TRADE DISCOURSE IN KENYA

SOME TOPICAL ISSUES

VOLUME 2

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Acronyms and Abbreviations

ACP	African Caribbean Pacific
CET	Common External Tariff
COMESA	Common Market for Eastern and Southern Africa
CU	EAC Customs Union
DDA	Doha Development Agenda
EAC	East African Community
EPAs	Economic Partnership Agreements
EU	European Union
FEPA	Framework Economic Partnership Agreement
FTA	Free Trade Area
GDP	Gross Domestic Product
LDCs	Developed Countries
MFN	Most Favoured Nation
MISMEs	Micro, Small and Medium Enterprises
NAMA	Non Agricultural Market Access
RTAs	Regional Trading Arrangements
S&DT	Special and Differential Treatment
SADC	Southern Africa Development Community
TC	Trade creation
TD	Trade diversion
TRAINS	Trade Analysis and Information System
WITS	World Integrated Trade Solution
WTO	World Trade Organization

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Foreward

CHAPTER 1

Assessing the Extent of Deep Integration within EAC: The Case of Kenya's Trade in Agricultural Commodities

Dr. Seth Omondi Gor

1.1. Background

East African Community (EAC) is a vibrant economic zone which is one of the fastest growing communities in the world. Over the period 2001-2009, the community grew at 5.8 percent per year. Except for ASEAN which grew at 6.1 percent, no other economic community in the world grew faster. Over the same period, each of the member countries more than doubled their own GDP. Although each member country attained tremendous growth, the same was unevenly distributed with Tanzania, Uganda and Rwanda growing at over 7 percent per year compared to Kenya and Burundi at 3 and 4 percent respectively. Each of the member countries of EAC today exports more to the region than to any other region. Between 2008 and 2010, the share of total EAC exports traded within the region increased from USD 1.8 billion to USD 2.2 billion, surpassing Europe as the region's main trading block. These gains notwithstanding, the community is still beset by a number of challenges.

The East African Community Treaty envisaged a complete integration of the partner states. Consummation of complete integration is bound to be beneficial to partner states in many ways. It has the potential to raise the productivity of factor inputs thereby leading to an increase in incomes; it can act to induce convergence of prices of like products and factors and of incomes within the community besides impacting positively on growth over time.

Two sets of policies are critical in the achievement of such a completely integrated market. The first set of measures relate to the elimination of border barriers to cross-border trade. They are the traditional focus of trade negotiations and of the GATT/WTO rules relating to Regional Trade Agreements (RTA) and they define integration in a narrow/shallow sense. In this regard, the EAC Customs Union Protocol requires duty free trade between

member countries. In response to this requirement, intra-regional tariffs have been reduced dramatically in the last two decades. In 1994, the number of tariffs stood at 26 percent but by 2011, this had been reduced to 10 percent. This suggests that there is quite some work to be done to fulfil this requirement.

The second set of measures is the subject of this study. They refer to the elimination of beyond-the-border laws and regulations that inhibit cross-border trade or delivery of services. They are the deep integration measures. From a general perspective, deep integration entails determining the appropriate institutional framework for dealing with externalities whether external or internal to the firm, industry, country or region or whether of an international nature. It also entails eliminating all barriers that may exist behind the borders between preferential partners, also referred to as Non-Tariff-Barriers (NTBs).

1.1.1. Status of NTBs in EAC

EAC (2012), provides a working definition of NTBs within EAC as "quantitative restrictions and specific limitations that act as obstacles to trade" (other than tariffs) that may be embedded in government laws, regulations and practices at the national and local level. So defined, NTBs constitute the single largest group of impediments to trade and business development in EAC. More specifically, intra-EAC trade is affected by the following NTBs; non-harmonized technical regulations, Sanitary and Phyto-sanitary (SPS) requirements, customs procedures and documentation, rules of origin and police road blocks (EAC, 2012).

In 2008, some 35 NTBs to trade were identified within EAC. Majority of these (12) were customs and administrative entry procedures while 11 were accounted for by business licensing and police road blocks. Technical barriers to trade were 4, SPS measures 5, charges on imports 2 and government participation 1. Whereas each of these NTBs had varying levels of political and economic complexity and significance, a majority of them (23) were rated to have low impact on EAC trade and 12 were rated as having high impact.

Whereas schedules for the elimination of these NTBs were agreed on way back in 2008, there has been very little progress in tackling them. In fact, new ones have since been introduced. This is compounded by incomplete implementation of EAC trade policy

commitments. For instance, despite commitments to harmonization, in practice, there is no formal structure for the application of SPS measures at the regional level.

1.1.2. NTBs Directly Affecting Imports

Customs procedures and documentation: Although the EAC Customs Union Protocol requires that customs formalities in the member states be based on standardized and harmonized documentation and procedures, little progress has been achieved in this regard. Pre-shipment inspection is still required by Burundi and Tanzania while on certain products, Kenya requires pre-shipment inspection by selected companies on TBT and SPS grounds.

Customs valuation: The principles of customs valuation require member countries to have uniform interpretation and application of community customs valuation provisions. In practice however, valuation procedures within EAC have not been harmonized. Efforts are however being made to address these challenges. A regional electronic valuation database is planned for June 2013 and a customs valuation manual has already been developed to enable uniform interpretation and application of EAC's customs valuation provisions.

Rules of Origin: EAC's certificate of origin was launched in 2007. The effectiveness of these rules have however been compromised by a number of issues key among them, the very wide diversity of issuing authorities and the very slow pace of implementation of the issuance procedures in some member states.

Standards and other technical requirements: EAC's Customs Union Protocol requires member states to remove all the existing NTBs and not to impose new ones. Although some 1200 voluntary standards have so far been harmonized for uniform application by member states, substantial progress still needs to be achieved in this direction. The protocol provides for the establishment of an East African Accreditation Board to promote, facilitate and coordinate accreditation activities but only one member-Kenya has an internationally recognized accreditation body. Besides, the recognition of certification marks among member states on goods that are traded regionally is also proving too difficult to implement.

Sanitary and Phyto-sanitary Measures: The Customs Union Protocol, with a view to protecting human, animal and plant life and health and promoting trade in agri-food products, provided for the development of harmonized SPS measures, the establishment of pest-free areas and the promotion of safe trade in agricultural products within EAC. In practice however, there is no formal structure for the application of SPS measures at the regional level. Consequently, full adoption and enforcement of harmonized SPS measures have not been achieved. If attained, this has the potential to rationalize development of agricultural production, enhance quality and increase trade within EAC.

1.1.3. NTBs Directly Affecting Exports

Documentation: Despite concerted effort, full harmonization of customs documentation for exports has not been attained within EAC. Presently, the number of documents required varies from one member country to another. In Tanzania for instance, five documents are required, compared to nine in Burundi.

1.1.4. NTBs Affecting Production and Trade

Competition policy and regulatory issues : The EAC Competition Policy adopted in 2004 and the Competition Act of 2006 contain provisions on abuse of market dominance, mergers and acquisitions, consumer welfare, member states subsidies and prohibits anti-competitive concerted practices.

To date, the Competition Act has not been operationalised. Effective implementation has been hampered by a number of challenges including lack of competition laws and institutions in some member countries, and technical capacity issues at national and regional levels. Presently, only Kenya and Tanzania have fully functional national competition authorities.

Intellectual Property Rights: The Common Market Protocol outlines a framework for regional cooperation in and harmonization of IPRs. Tremendous progress has been registered in this front, particularly with regard to facilitation of manufacture and imports of essential medicines. The biggest challenge however, remains the low level of awareness

within key stakeholders on the role of intellectual property in facilitating manufacturing capacity in the region.

1.1.5. NTBs and Kenya's Trade in Agricultural Commodities within EAC.

Agriculture is the leading economic sector in the EAC region, with more than 80 percent of the population securing their livelihood from it. Formulation of agricultural policies remains largely the jurisdiction of various partner countries, even though EAC has developed a yet to be implemented Agriculture and Rural Development Policy and Food Security Action Plan.

According to the WTO, food security should be the primary objective of national agricultural policies. In EAC however, support for the agricultural sector is luke-worm among the public and in many cases, the regulatory intervention by the government is seen to be not only excessive, but also distortive. This notwithstanding, EAC member countries face serious supply constraints on competitive agricultural production ranging from poor road infrastructure to high energy costs. Besides, reliance on traditional farming methods means that EAC economies are vulnerable to weather- related developments. The consequence of this is that some EAC member countries, including Kenya, are food deficit countries.

World Bank (2012), reports that Kenya and Uganda are guilty of imposing more rules and regulations on their regional imports than many comparator countries in Sub-Saharan Africa. In addition the report suggests that among comparators including Senegal, Madagascar, Mauritius, Namibia and Uganda, Kenya is the only country that imposes more rules and regulations on imports from its regional partners than on imports from the rest of the world.

A wide variety of sectors are adversely affected by the many rules and regulations imposed by Kenya but notable among them are the agricultural commodities which include food and feed. This is however, not unusual. Control of agricultural commodities, particularly food and feed is necessary to ensure among others; health of consumers, and protection of the environment. The main rules for achieving these are the Sanitary and Phyto-Sanitary (SPS) measures. SPS measures cover 75 percent of the food products in

Kenya. The other rules and regulations affecting agricultural commodities are the inspection rules as well as the TBT measures- which result from poor application of rules and regulations and which cover 60 percent of food products in Kenya compared to 20 percent average for other countries.

The effect of these many rules and regulations is that they constrain the daily operations of producers and traders within the RTA. SPS and TBT measures increase costs of production for both domestic and foreign producers thereby deterring food imports by hampering production potential in food surplus countries in EAC and raising domestic prices of food products.

World Bank (2012) reports that the poorest households; because they consume relatively more of food products suffer the most from the price-raising effect of rules and regulations affecting agricultural commodities. They demonstrate that the poorest 20 percent of households in Kenya for instance, experience on average a 23 percent rise in prices compared to 14 percent rise for the 20 percent richest households.

The foregoing analysis suggests that even though there may be valid reasons for introducing rules and regulations in an RTA, the same can easily become NTBs if they are restrictive in nature or if they are poorly designed or poorly implemented. This is confirmed by the World Bank (2012) listing of a number of NTBs affecting the food sector in Kenya (Table 1.1) and which though already identified are yet to be eliminated.

NTBs Affecting the Food Sector in Kenya:
Table 1.1: NTBs Affecting the Food Sector in Kenya:

NTB Summary Description	Affected Country	Bottleneck Preventing Action
Non recognition by Kenya of SPS certificates issued by Uganda for tea destined for Mombasa Auction	Uganda	Resistance from issuing authority
Charges on plant import permit at Malaba on Ugandan tea destined for Mombasa auction	Uganda and Burundi	Resistance from issuing authority
Uganda ban on beef and beef products from Kenya	Kenya	Pressure from businesses not to recognize products from within EAC due to fear of loss of market
Uganda's certification procedures on exports of milk from Kenya	Kenya	Pressure from businesses not to recognize products from within EAC due to fear of loss of market
Charge of Kshs 5000 by Kenya Plant Health Inspectorate Services for every truck entering Kenya carrying Rwandan tea	Rwanda	Unknown
Complaints on administrative delays in maize clearance in Busia and Malaba borders	Uganda	EAC SPS protocol to address the matter
Cumbersome registration, testing and certification procedures for food products	Kenya	Insistence by Tanzania Food and Drug Administration to duplicate efforts of the KEBS
Wheat flour value addition into Rwanda and Kenya	Tanzania	Unknown
Konyagi has been refused entry into Kenya for not meeting international standards of alcohol content of 37.5% vs 35%	Tanzania	Kenya must be willing to accept Konyagi

Source: World Bank (2012)

1.1.6. NTBs, Deep Integration and Global Value Chain Analysis

An RTA like the EAC is the first step to deep integration of member states in the sense that it creates a common economic space for all partners. Deep integration makes it possible for member countries to experience higher welfare gains which arise from the direct impacts of technology, technology use and productivity, as well as from any spillover effects and externalities. Literature suggests that much of such additional gains are likely to be generated from greater supply chain integration. Hence the greater these possibilities are, the more likely it is that there will be welfare gains.

Literature suggests that the relationship between Global Value Chains (GVCs) and Deep Integration (DI) is bi-directional. NTBs, by impeding greater supply chain integration, therefore reduce the possibility of deep integration and vice-versa. Deep Integration allows firms within an RTA better access to value chains by nurturing finer "niche" specialization across member states and also by creating stable regional value chains. Significance of NTBs can therefore be seen in the light of their adverse effect on intra-industry trade and vertical intra-industry specialization respectively.

In East Africa, there is a likelihood of deep integration being slowed down by various NTBs which are caused by the partner governments' indifference to "National Treatment" requirements of the WTO. Within EAC, this indifference is fuelled largely in part by suspicions premised on very limited information on the possible impact of such integration on the economies of the partner states.

The present study seeks to fill this information gap with a view to supporting policy decision making in this area. It explores the integration process through the study of value-chains as opposed to the more conventional global trading networks. The basic motivation is that value chain analysis provides insights on some of the most critical issues that drive market integration today. These include; institutional changes that lower transaction and information costs that act as barriers to trade between countries; structural changes in markets that permit economic groups in those markets to internalize externalities generated from globalization and finally the speed of institutional and structural changes that affect the speed of integration.

Besides, GVC analysis makes it possible to identify the leading firms in every segment of the value chain. The presence of such firms can then be mapped to relevant member countries to inform country level positions within the chain. In this way, it becomes possible to determine the contributions of different member countries within the chain to deepening or otherwise of the integration process.

The objectives of this paper are twofold. First, it seeks to assess the potential for deep integration in EAC and second, it seeks to determine the extent if any, of deep integration in EAC.

1.2. Value Chain Approach in Perspective

Majority of studies interrogate integration from the global trading network perspective. There are however, a handful that pioneered the perspective we choose to follow in this paper. Lawrence (1996) in his analysis of deep integration stressed the link between coordination and integration as espoused in the value chain approach. On the basis of this approach, he defined deep integration to mean the elimination of differences in national production and product standards, secure access to large foreign markets and the removal of barriers to regional production systems.

Using the same approach, Birdsall and Lawrence (1999) concluded that deeper integration among nations brings integration not only in production of goods and services but also in standards and other domestic policies. Gibbon (2001) identified a form of coordination seen particularly within chains of traditional primary commodities, which he terms "trader-driven" which is a function of upstream networks of trade and finance as well as of permanent downstream horizontal networks.

Velkar (2010), used Global Commodity Value Chain approach to explore the dynamics underlying integration of the grains market. His study findings demonstrated that deep integration imply changes to market structures, firm strategies and the commodity being marketed.

Some studies have observed a systematic link between GVCs and deep integration. According to Lawrence (1996), GVCs cannot operate smoothly unless national policies are harmonized to facilitate business activities taking place in a group of countries- which in essence is a direct demand for deep forms of integration.

Antras and Staiger (2008) concluded that an increase in trade flows involving the exchange of customized inputs, incomplete contracts and search costs for foreign input suppliers did create new forms of cross-border policy effects compared to a situation in which goods are produced in a single location. They argue that this very changing nature of trade is what creates demand for deeper forms of agreements to help address the emerging cross-border challenges.

Orefice and Rocha (2011) argue that even though a positive relationship between GVCs and deep integration is obtainable, the relationship is bi-directional. They contend that deep integration can stimulate the creation of GVCs by facilitating trade among potential members of a supply chain but that countries already involved in GVC are willing to sign deeper trade agreements with their partners in order to secure trading relationships as providers of intermediate goods and services. Using a two-step Heckman selection model, they showed that the greater the depth of integration, the bigger will be the increase in network trade among member countries. They concluded that on average, signing deep agreements increase trade in production networks between member countries by almost 35 percentage points.

Some studies have sought to confirm whether higher levels of network trade (GVCs) increase the likelihood of signing deeper agreements. Baier and Bergstrand (2004) and Baier, Eggar and Larch (2010) attempt to identify determinants of PTA by estimating an equation in which the dependent variable is the depth of integration and the share of trade in parts and components over total trade, the explanatory variable.

1.3. Analytical Framework

At present, no standard theoretical framework exists for measuring the degree of deep integration or for determining its impact on RTA members or even the rest of the world. Our analysis proceeds in two distinct stages. In the first stage we assess, on the basis of predetermined elements, the potential for integration within EAC. In the second stage, we estimate three intra-industry trade indicators namely Inter-Industry Trade Index (IIT); Vertical Intra-Industry Specialization Indicator (VIIS) and Revealed Market Access indicator (RMA) with HS 96 nomenclature at a 6-digit level of aggregation with a view to confirming the possibility and also the extent of deep integration in trade in agricultural commodities.

1.3.1. Assessing the Potential for Deep Integration

There's no existing framework within which the potential for deep integration in an RTA can be assessed. However, many attributes of new regionalism such as segmentation of production processes that result into international value chains involve elements of

externalities. This makes it possible to assess the potential for deep integration by focusing on an important aspect of externalities, namely the potential role of policies that facilitate or generate externalities through deep integration. Such policies do not only define important elements of deep integration; the extent to which they have been implemented is also a good indicator of deep integration. They include:

(1) Tariff – like measures

(2) Regulatory norms

(3) Investment rules

(4) Competition policy alignment

(5) Rules on subsidies in addition to WTO rules

(6) Services schedules relative to GATS commitments

(7) Rules on movement of natural persons

(8) Harmonization of intellectual property rights

(9) Institutional framework

10) Financial arrangements

1.3.2. Determining the Extent of Deep Integration in EAC

To determine the extent of deep integration in EAC, we use WITS dataset to estimate three indicators of deep integration namely Intra-Industry Trade Index (IIT), Revealed Market Access (RMA) and Vertical Intra-Industry Specialization Index (VIIS) with Kenya as the reporter country and Uganda and Tanzania as the partner countries. These three are chosen first because they are the longest serving members of EAC and therefore have the capacity to demonstrate impact but also because between themselves, they have the largest flows in terms of intra-country trade.

1.3.2.1. Intra-Industry Trade Index

Intra-Industry Trade Index (IIT) shows the level of similarity in the pattern of trade across products of imports and exports. It is measured by the Grubel-Lloyd index which shows the overlap of imports and exports at a given level of aggregation. The IIT is an indicator of deep integration between countries since Deep Integration (DI) is associated with high vertical specialization along value chains

Trends of IIT overtime is therefore indicative of underlying changes taking place in member countries of an RTA and also of the changes in the type of trade taking place between them. It illuminates the major political economy consideration in a country and also the possible future direction of trade policy

IIT can be calculated at disaggregated level for individual sectors, subsectors or products. This further allows for calculation of a summary measure across sectors, subsectors or products. The G-L index of trade between countries i and j in good k is expressed as;

$$GL_{ij}^k = 1 - \left(\frac{\left| x_{ij}^k - m_{ij}^k \right|}{x_{ij}^k - m_{ij}^k} \right)$$

Where: x_{ij}^k denotes exports from the country i to country j of commodity k

m_{ij}^k denotes imports from country i to country j of commodity k

The G-L index across all goods can then be expressed as:-

$$GL_{ij} = \sum_k GL_{ij}^k \left(\frac{x_{ij}^k + m_{ij}^k}{x_{ij} + M_{ij}} \right)$$

$$= 1 - \sum_k \frac{\left| x_{ij}^k + m_{ij}^k \right|}{x_{ij} + M_{ij}}$$

Conventionally this index can be calculated as a weighted (disaggregated) or unweighted average (aggregated). Tradesift permits us to perform both; by choosing a given level of aggregation e.g. HS 2-digit. This index measures the proportion of trade that is overlapping.

If all the trade in sector k is one-way trade such that x_{ij}^k or m_{ij}^k is zero; then $GL_{ij}^k = 0$. If all the trade in every sector is one-way trade; $GL_{ij} = 0$ and all trade is then inter-industry trade. If however trade in sector k is equal in both directions, such that $x_{ij}^k = m_{ij}^k$; then $GL_{ij}^k = 1$. If on the other hand trade in every sector is equal in both directions and $GL_{ij} = 1$ then all trade is intra-industry trade.

1.3.2.2.   Revealed Market Access (RMA)

This index is used to compare the extent to which one country has access to two or more different country markets for instance, Kenyan export access to Uganda relative to Rwanda. Since the level of export into a given market is determined by the size of that market, the normal practice in company exports across two markets is control for size by normalization. RMA can b normalized by GDP or by the total level of imports.

When normalized by GDP, RMA is calculated as follows;

$$RMA_{ij_1,j_2}^k = \left(\frac{x_{ij_1}^k}{x_{ij_2}^k}\right)\left(\frac{GDP_{j_2}}{GDP_{j_1}}\right)$$

Where: k is the industry

i is the country of origin

j_1 and j_2 are the destination countries

When normalized by imports then RMA is calculated as:

$$RMA_{ij_1,j_2}^k = \left(\frac{x_{ij_1}^k}{x_{ij_2}^k}\right)\left(\frac{\Sigma_i M_{j_2}}{\Sigma_i M_{j_2}}\right)$$

When RMA >1 then exports for a given product is higher in one market than in another. For values of RMA < 1; the converse is true. There are several factors that could result into

trade in particular products being higher in one market than in another, such as distance, levels of trade facilitation, language and trade barriers. An RMA that is less than 1 could therefore be caused by trade barriers in one market or be caused by any of the other factors listed. RMA can therefore provide a possible indication of any trade barriers in a given market.

1.3.2.3. Vertical Intra-Industry Specialization Index (VIIS)

VIIS looks at trade flows in different levels of a supply chain. It is estimated as a ratio of intermediate goods imported from A to final goods exported to B. That is, the share of imports of intermediate goods in country's total exports of final goods. It therefore captures the degree of possible vertical specialization within an industry hence indicator. A variant of the VIIS is the Intra-Industry Trade Index (IIT). The IIT ranges from -1 to 1. It gives a measure of the degree of similarity in the value of trade in the intermediate and final goods and is expressed as;

$$IIT = \frac{1 - F}{1 + F}$$

Where; I is the imports or intermediate goods from a given source and F is the exports of a given category of goods e.g. the final goods to either the same source or elsewhere. For I=F, the value of the index=0 and the greater the difference between I and F, the bigger in absolute terms the index gets. When I is much bigger than F, then the index approaches 1 and if F is much bigger than I, then the index approaches -1.

1.4. Discussion of Results

1.4.1. Assessment Outcomes

Tariff-Like Measures: Relevant policy measures have been put in place within EAC with regard to tariff-like measures. The EAC's 2011 Common External Tariff (CET) is composed of 5274 tariff lines; 99.8% of which carry ad valorem duties with the rest carrying mixed tariffs. The CET does not contain any seasonal or variable tariff quotas, a situation which has worked in favour of Deep integration.

Since 2010, all members have eliminated tariffs on intra-EAC trade, but tariff preferences granted on a reciprocal basis with third party countries differ from one member country to another. Members have further agreed to harmonize their duty and tax exemption and concession schemes as stipulated in the EAC Customs Management Act.

The internal tax systems of individual members has however, worked to distort cross border transactions especially on capital and labour flows. This is largely due to the fact that the definitions of tax bases and rates, as well as the experience of VAT use vary from one country to another. Besides, the national legal framework supporting excise duties also vary across member states in EAC.

Regulatory Norms: The existence of an RTA makes it possible for member countries to deal with regulatory norms and standards governing trade and which are a lot more difficult to handle multilaterally. Such norms are particularly critical because they can be used to facilitate deep integration but they can also be used as regulatory barriers to frustrate deep integration. Deep integration requires that regulatory norms be harmonized within an RTA.

The member countries of EAC have formulated norms on standards and technical requirements but substantial progress still needs to be achieved in this direction. The East African standards committee; composed of representatives of the various national quality system institutions and of the private sector is mandated to develop new standards and to harmonize existing ones. By 2012 it had harmonized 1200 voluntary standards for uniform application within the region. The norms prescribe accreditation structures at national and regional levels but Kenya is the only member country with an internationally recognized accreditation body in the RTA.

Recognition of certification marks among EAC countries on regionally traded goods has also proved difficult to implement for which reason the council of ministers approved a regional regulation to further promote the recognition of certification marks within the region commencing in 2012.

Investment Rules: Evidence suggests that investment follows trade. Where an RTA is trade creating, it's expected that it would attract FDI. Investment flows could therefore be indicative of deep integration. Within the EAC, administrative, regulatory and legal frameworks have been developed by individual countries to strengthen and stabilize national investment policies and to improve and create investor-friendly national environment.

In all the five member countries, investment promotion authorities have been established to promote domestic and foreign investment and Public-Private Partnership (PPP) platforms have been initiated in most of the member countries. This notwithstanding, performance in attracting investments from third party countries still varies from one country to another. Over the last five years for instance, Uganda and Tanzania were the major destinations within the RTA as the total intra-EAC investments increased from USD 83 million in 2007 to USD 530 million in 2008.

This growth momentum has since subsided but Kenya continues to be the main source of intra-EAC investments. Overall, there has been an increased flow of investment into the region; an indication of the potential for deep integration.

Competition Policy Alignment: Competition policy alignment is indicative of deep integration because it serves to level the ground for all firms thereby increasing trade. EAC as an RTA has not managed to regulate competition issues at the regional level. At the national level however, Kenya and Tanzania have put in place fully functional competition laws and institutions. This has made it difficult to align competition policy across the RTA. By 2012, the EAC competition Act faced a number of challenges including lack of competition laws and institutions in some states and technical and capacity issues at national and regional levels respectively.

Rules on Subsidies in Addition to WTO Rules: Given the adverse effects of subsidies in terms of distorting the pattern of production as well as the favorable effects of the same especially if targeted on correcting externalities, it follows that existence of such rules is indicative of deep integration.

Article 20 of the Customs Union protocol outlines rules on subsidies. It calls on EAC member countries to cooperate in the detection and investigation of subsidies and in the imposition of measures to curb the practice among others. The protocol requires that EAC countries impose countervailing measures to offset the effect of subsidies. It prescribes a countervailing duty equal to the amount of the subsidy estimated to have been granted on the production or export of the good. Adherence to these commitments has not taken off largely because the proposed committee on Trade Remedies intended to oversee implementation has so far not been established.

Services Schedules Relative to GATS Commitment: Trade in services has gained global significance in world trade today. However, given the unique and complex nature of trade in services in which barriers take the form of regulation that applies not to the service itself, but rather to the service provider; (for instance recognition of professional qualifications for individuals and regulatory certification for firms), a good proxy for deep integration is the extent to which an RTA provides for and implements relevant service schedules as opposed to merely reaffirming GATS schedules.

Although the Annex on Mutual Recognition of Academic and Professional Qualifications has been adopted and a number of bilateral MoUs concluded for various professions including lawyers, medical boards, architects and accountants in member states, the Common Market Protocol simply reaffirms, under Article 23, the specific commitment schedules under GATS; a fact that does not bode well for deep integration.

Rules on Movement of Natural Persons: The extent to which visa requirements in an RTA facilitate movement of personnel across borders is also an indicator of deep integration. In EAC, the Common Market Protocol of 2010 provides for various rights and freedoms including free movement of goods, capital, services and labour. Full implementation of the Customs Union has continued to encounter major challenges thereby impacting adversely on deep integration. We can therefore only expect that additional commitments under the Common Market Protocol will be addressed progressively.

Harmonization of Intellectual Property Rights: The extent to which RTAs provide for harmonization of IPRs is a good indicator of deep integration especially if the provisions

are stricter than WTO rules, e.g. "TRIPS +" conditions. In EAC, the framework for regional cooperation and harmonization of IPRs policies is set out in Articles 103 of the Treaty and Article 43 of the Common Market Protocol.

Evidence show that harmonization within the community is well on course. A draft protocol and policy on utilization of Public-Health related WTO-TRIPS flexibilities was adopted by sectoral council of ministers in 2011 and is due for finalization in 2013. The basic challenge to development of the policy and protocol however, remains the low level of awareness by major stakeholders of the role of IPR in development.

Institutional Framework: In a credible RTA, a strong institutional framework is indicative of potential for deep integration because such a strong framework ensures provision of technical support to facilitate implementation and permit adherence to commitments. The institutional framework for EAC is spelt out in its successive development strategies as one of the key priority areas to be addressed with a view to implementing the Common Market Protocol, consolidating the Customs Union and enhancing productive capacity and competitiveness. The most recent of such strategies is the 2011-2016 development strategies.

By 2012, the original institutional framework had not changed much. The major organs included; the summit of Heads of State and/or Government, the Council of Ministers; the Coordination Committee; the sectoral committees; the East African Court of Justice; the East African Legislative Assembly and the Secretariat. The effectiveness of this framework is however in doubt owing to limited enforcement of adherence to commitment schedules this far.

Financial Arrangements: To facilitate compensation and push an RTA towards becoming a genuine and fully functional Customs Union (a major ingredient for deep integration) an integrated financial framework is necessary. In order to facilitate the establishment of a monetary union within EAC, member countries agreed on a macroeconomic convergence criteria/framework which covered the period 2007-2010. The framework included:

(a) An overall budget deficit (excluding grants) to GDP ratio of not more than 6%; and an overall budget deficit to GDP (including grants) of not more than 3%.

(b) An annual average inflation rate not exceeding 5%.

(c) External reserves worth more than four months of import cover.

This framework also included eight qualitative indicators covering such issues as sustainability and stability of exchange rates, real GDP growth and the RTA's financial situation. Inspite of this framework being in place, not much has been done to implement it owing to major challenges in implementation of the Customs Union and the Common Market Protocol. In fact the deadline for implementation of this schedule (April 2012) has since passed by more than a year as member countries continue to conduct their macroeconomic policies independently.

1.4.2. Estimation Results

Using WITS dataset for the period 2007-2010, with HS96 nomenclature at the 6-digit level of aggregation, we estimated the Vertical Intra-Industry Specialization index for Kenya, Tanzania and Uganda with Kenya as the reporter country and Tanzania and Uganda as the partner countries. The results are reported in Table 1.2.

Table 2 shows that for all the 31 agricultural products reported for Tanzania in 2007, only 7 products had high values (values approaching 1) that indicated strong participation in value chain activities. This trend is repeated in 2008 and 2009 but in 2010 the numbers reduced to only 6 products. This is overwhelming evidence of little value chain activity in trade between Kenya and Tanzania which is indicative of lack of deep integration in the RTA.

The situation is however, much better in Kenya's trade with Uganda. In 2007, 15 out of the 31 products reported had values high enough to suggest strong participation in value chain activities. This declined to 8 products in 2008 but increased again to 9 in both 2009 and 2010. Although the figures look better for Kenya's trade with Uganda, for the four episodes analyzed, less than half the total number of agricultural products reported sufficiently high values with about one third of the products showing values suggesting limited value chain activity which imply very low levels of deep integration.

Using gross import and export data, we also estimated the Intra-Industry Trade index between Kenya and Uganda for 287 products at a high level of disaggregation (6-digit) with a view to capturing vertical specialization (value chain activity). Table 1.3 reports the 46 commodities that had an IIT value that was different from zero.

The results show that for 243 products out of the total of 287 products examined the Grubel-Lloyd (G-L) index was zero an indication that for 84.7% of the agricultural commodities traded between Kenya and Uganda, trade was one-way hence 84.7% of trade was inter-industry trade. Out of the remaining 16% (that is reported in Table 3), only 8 of the 46 commodities registered G-L values that tended towards 1 and in fact none of the said values could be rounded-up to 1. This shows that for the year in question, there was absolutely no intra-industry trade between the two countries.

In view of the fact that Uganda is the major recipient and Kenya the main exporter within EAC, these results therefore corroborate the VIIS estimates which show limited value chain activity and by extension, low levels of deep integration within the RTA.

Table 1.2: Kenya's VIIS with Uganda and Tanzania for the Period 2007-2010

PRODUCTS	TANZANIA				UGANDA			
	2007	2008	2009	2010	2007	2008	2009	2010
Live animals	-0.60	-0.96	-1.00	-0.88	1.00	-0.90	-1.00	-0.99
Meat and edible meat offal	---	-1.00	---	---	---	0.00	---	---
Fish, crustaceans, molluscs	---	---	0.00	---	---	---	-1.00	---
Dairy products, eggs, honey	-1.00	-1.00	-1.00	-1.00	0.00	-1.00	0.40	0.96
Product of animal origin	0.86	0.98	1.00	0.99	1.00	0.96	0.99	1.00
Live trees, plants, bulbs, roots	-1.00	-0.60	-1.00	-0.96	1.00	-0.99	-0.80	-0.70
Edible vegetables, roots, tubers	---	0.00	1.00	---	---	1.00	1.00	---
Edible fruit, nuts, citrus, melon	-1.00	-1.00	-0.95	-0.94	0.00	-1.00	-1.00	-1.00
Coffee, tea, mate and spices	-1.00	-1.00	-1.00	0.98	0.00	0.00	0.00	0.82
Cereals	0.78	0.50	0.23	-0.38	1.00	0.40	0.63	0.88
Milling products, malt, starch	-0.65	-1.00	-0.99	-0.57	1.00	0.93	-1.00	-1.00

Oil seed, oleagic fruits, grain	0.16	0.50	0.50	0.04	1.00	0.91	0.88	0.85
Lac, gums, resins, vegetables	-1.00	-1.00	0.04	-0.11	0.00	-1.00	-1.00	-1.00
Vegetable plaiting materials	0.97	-1.00	0.84	0.81	1.00	-1.00	0.00	-1.00
Animal, vegetable fats and oils	-0.40	-0.30	-0.83	-0.95	1.00	-0.87	-0.80	-0.92
Sugars and confectionary	-0.50	-0.60	-0.54	0.33	0.00	-1.00	0.64	0.31
Cocoa and cocoa preparations	-1.00	-1.00	-1.00	-1.00	0.00	-1.00	-0.80	-0.30
Miscellaneous edible preps	-1.00	-1.00	-1.00	-1.00	0.00	-1.00	-1.00	-1.00
Beverages, spirits, vinegar	-1.00	-1.00	-1.00	-1.00	0.00	-1.00	-1.00	-1.00
Residues, animal fodder,	0.92	0.90	0.87	0.87	1.00	0.90	1.00	0.87
Tobacco, mfct tobacco subst.	-0.99	0.92	1.00	0.01	1.00	0.90	0.60	0.99
Rubber and articles thereof	-0.87	-0.86	-0.92	-0.71	1.00	-1.00	-1.00	-1.00
Raw hides and skins	0.33	0.99	0.98	0.98	1.00	1.00	0.93	0.99
Articles of leather, animal gut	-1.00	---	---	---	0.00	---	---	---
Furskins and artificial fur	---	-1.00	0.00	---	---	-1.00	-1.00	---
Wood and articles of wood	0.75	0.21	-1.42	0.06	1.00	-0.13	-1.00	0.08
Pulp of wood, cellulosic waste	0.81	-0.40	0.25	-0.70	1.00	-0.96	-1.00	0.44
Silk	---	0.00	0.00	---	---	-1.00	-1.00	---
Wool, animal hair, horsehair	-1.00	-1.00	-1.00	-1.00	0.00	-1.00	0.00	-1.00
Cotton	0.90	0.92	0.92	0.78	1.00	0.89	0.88	0.91
Vegetable textile fibres nes,	0.30	-0.65	-0.81	0.31	0.00	-1.00	-1.00	-1.00

Source: Author's estimates using WITS dataset

Table 1.3: Intra-Industry Trade index between Kenya and Uganda (2010)

Product Code	Product Name	IIT	Product Code	Product Name	IIT
10511	Fowls, live domestic	0.035	120999	Seed, fruits	0.166
30420	Fish fillets, frozen	0.023	151190	Palm oil or fractions	0.064
40110	Milk not concentrated	0.223	151219	Sunflower or safflov	0.058
40120	Milk not concentrated	0.243	151590	Vegetable fats, oils nes	0.076
40210	Milk Powder <1.5%	0.366	151620	Vegetable fats, oils	0.421
40510	Butter	0.557	170111	Raw sugar, cane	0.01
40590	Other milk fats	0.87	170310	Cane molasses	0.053
51191	Fish, shell fish	0.096	180100	Cocoa beans, whole	0.071
60210	Cuttings and slips	0.27	200490	Vegetable nes	0.794
71339	Beans dried	0.005	200820	Pineapples	0.321
71390	Leguminous vegetables	0.039	200919	Orange juice	0.928
80290	Nuts edible, fresh	0.207	200920	Grapefruit juice	0.028
90111	Coffee, not roasted	0.004	200930	Citrus juice nes	0.192
90190	Coffee husks	0.014	200940	Pineapple juice	0.774
90240	Tea, black (fermented)	0.031	200960	Grape juice	0.229
100510	Maize (corn) seed	0.05	200970	Apple juice	0.727
100590	Maize except seed	0.015	200980	Single fruit, vegetable juice	0.599
100630	Rice, semi-milled	0.402	200990	Mixtures of juices	0.439
100700	Grain, sorghum	0.5	210690	Food preparations	0.109
100890	Cereals, unmilled	0.014	220429	Grape wines, alcoholic	0.081
110290	Cereals flour	0.001	220890	Alcoholic liqueurs	0.243
120210	Groundnuts in shell	0.011	230990	Animal feed preparations	0.444
120810	Soya beans flour	0.106	240120	Tobacco, unmanufactured	0.047

Source: Author's own estimates from WITS dataset

In order to compare the extent to which Kenya has access to Ugandan relative to the Tanzanian market, we estimated the Revealed Market Access index (RMA) for the year 2010. We controlled for market size by normalizing the RMA by GDP at constant prices. A total of 338 agricultural commodities were analysed out of which 212 returned an RMA value of zero.

Table 1.4 in the appendix reports only the 126 commodities that registered positive RMA values. Of the 126 commodities, 100 registered RMA values greater than 1, implying that exports for 29.5% of all the agricultural commodities was higher in the Ugandan market relative to the Tanzanian market for Kenyan commodities. These results suggest that there were more barriers to trade for Kenyan exports in Tanzania compared to Uganda, implying that the depth of integration was generally higher with Uganda, than with Tanzania. Overall, these results also corroborate those of VIIS and IIT, that the levels of deep integration within EAC are generally very low.

1.4.3.   Conclusion and Policy Suggestions

Assessment outcomes based on the major elements of deep integration suggest that there is real potential for deep integration in the form of appropriate rules, schedules and policy measures. There is however, overwhelming evidence that the said rules and policy measures are not being implemented according to the laid down time schedules and in fact some are totally ignored by member countries. This has acted to create imbalances in trade flows as members jostle for relative vantage positions through such unorthodox means as erecting new trade barriers instead of removing the existing ones. These results suggest limited scope for deep integration in the present and immediate future. The empirical results corroborate this conclusion and suggest further that deep integration is more likely between Kenya and Uganda than between Kenya and Tanzania.

The results of this study should help regional policy makers infer the distance to be covered to full integration and the role of trade in agricultural commodities in facilitating this, both of which will imply focus on specific policy options and instruments. In this regard, effort should be made to assess the structure, conduct and performance of the entire regional

market with a view to positioning the region for active participation in Global Value Chains.

In EAC, a natural starting point is the strengthening and deepening of the integration process by first implementing in a timely and uniform manner, the various schedules provided for in the protocol. This should provide a platform for Global Value Chain to act as an anchor for development and also to provide a basis for upgrading the regional market for agricultural commodities. This should give way to the development of a regional policy framework for Global Value Chains as well as the development of requisite infrastructure for GVC participation.

Second, there is need in the region, for more finely targeted policies to support GVCs in the agricultural sector with a view to moving away from the traditional policies aimed at developing production capacity for final goods. This is likely to raise the competitiveness of agro-products by facilitating an upgrade to higher value tasks within the industry.

To countenance the potential adverse effects of GVCs, it may be necessary for the region to develop policies to deal with the risks associated with any of the member countries getting stuck in low in low value-added tasks and activities in the chain.

It may also be necessary for the region to re-orient its existing trade policies to support greater GVC integration by for instance discarding the various protective trade policies. Protective trade policies have the potential to backfire because in the trade in agricultural commodities, imports are crucial for exports, which suggests that NTBs to imports then constitute an impediment to export competitiveness.

Finally, all the member countries should follow in the footsteps of Kenya and Tanzania to create competition authorities and to develop competition policies to help in the management of power relations that are bound to arise from participating in GVCs. Such policies should also be useful in helping to prevent or sanction anti-competitive behaviours especially of leading players as the region increases progressively, its participation in Global Value Chains.

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1.6. Appendix

Table 1.4: Revealed Market Access for Kenya in Uganda relative to Tanzania (2010)

| | Partner 1 - Uganda | | | Partner 1 - Uganda | |
| | Revealed Market Access (RMA) | | | Revealed Market Access (RMA) | |
Product Code	Product Name	RMA	Product Code	Product Name	RMA
10210	Bovine Animals, live	8.274	80111	Coconuts, dessicate	0.209
10511	Fowls, live domestic	0.338	80290	Nuts edible, fresh	39.778
10600	Animals, live	0.879	90121	Coffee, roasted	14.631
20329	Swine cuts, frozen	0.339	90190	Coffee husks	1.209
20442	sheep cuts, bone in	0.11	90220	Tea, green	1.37
21011	Hams and shoulders	0.211	90230	Tea, black (fermented)	0.085
21019	Swine meat, salted	0.629	90240	Tea, black (fermented)	0.405
30410	Fish fillet or meat	16.526	91010	Ginger	2.918
30530	Fish fillet, dried	2.05	91091	Mixtures & spices	3.311
40110	Milk not concentrated	1.266	91099	Spices nes	11.007
40120	Milk not concentrated	46.124	100110	Durum, wheat	61.023
40130	Milk and cream	0.186	100510	Maize (corn) seed	0.335
40210	Milk powder	14.605	100640	Rice, broken	5406.66
40291	Milk and cream	3.503	100890	Cereals, unmilled	1.117
40299	Milk and cream	5.058	110220	Maize (corn) flour	15.157
40310	Yogurt	5.738	110412	Oats, rolled or flake	6.503
40390	Buttermilk, curdled	0.777	110812	Maize (corn) starch	0.516
40510	Butter	0.209	120100	Soya beans	0.011
40520	Dairy spread	0.012	120810	Soya beans flour	2.082
40590	Other milk fats	0.411	120924	Seed, forage plants	40.88
40630	Cheese processed	0.005	120991	Seed vegetable	3.429
40690	Cheese except fresh	2.889	1210999	Seed, fruits	78.22
40900	Honey natural	8.861	121490	Other fodder	97.553
60210	Cuttings and slips	3.101	130190	Natural gum, resin	0.129
60240	Roses	29.613	130232	Mucilages & thicken	0.363
60290	Plants live, mushroom	0.024	130239	Mucilages & thicken	132.654

Product Code	Product Name	RMA	Product Code	Product Name	RMA
60390	Cut flowers	26.78	140490	Vegetable, products	7.731
70110	Potatoes seed, fresh	6.662	150590	Derivatives of wool	0.095
70200	Tomatoes, fresh	0.178	150910	Olive oil, virgin	0.706
70320	Garlic, fresh or chilled	1.179	151190	Palm oil or fractions	0.454
71190	Vegetables	8.121	151219	Sunflower	3.177
71310	Peas dried, shelled	24.976	151319	Coconut oil (copra)	0.006
71339	Beans dried, shelled	0.337			
151529	Maize oil, fractions	1.324	200540	Peas	0.681
151550	Sesame oil or fractions	2.241	200551	Beans, shelled	2.712
151620	Veg fats, oils or fractions	0.346	200559	Beans nes,	1.276
151710	Margarine	1.167	200570	Olive, Prepared	4.12
151790	Edible mix & preparation	1.437	200580	Sweet corn, prepared	42.412
152000	Glycerol crude	1.485	200590	Veg nes mixes	0.458
170199	Refined sugar	0.503	200600	Fruits, nuts	0.788
170219	Lactose	0.978	200819	Nuts seeds	1.785
170220	Maple sugar	0.092	200820	Pineapples	22.495
170230	Glucose, glucose syrup	8.119	200870	Peaches	1.363
170240	Glucose	1.258	200899	Fruits, edible plants	5.691
170290	Sugar nes	0.599	200919	Orange juice	0.61
170390	Molasses	52.759	200920	Grape fruit juice	4.139
170490	Sugar confectionery	0.334	200930	Citrus juices nes	0.793
180500	Cocoa powder	0.458	200940	Pineapple juice	0.893
180610	Cocoa powder	0.274	200950	Tomato juice	1.004
180620	chocolate	1.578	200970	Apple juice	0.424
180631	chocolate, cocoa	0.122	200980	Single fruit, veg juice	0.307
180690	Chocolate/cocoa	0.858	200990	Mixtures of juices	0.62
190110	Infant foods	0.693	210111	Coffee extracts	5.97
190190	Malt extract	0.81	210130	Chicory	1.207

Product Code	Product Name	RMA	Product Code	Product Name	RMA
190219	Uncooked pasta	10.011	210310	Soya sauce	0.727
190230	Pasta except uncooked	10.439	210320	Tomato ketchup	0.181
190410	Cereal foods	4.469	210330	Mustard flour	2.028
190490	Cereals	6.421	210390	Sauces nes,	7.135
190590	Communion waters	17.205	210690	Food preparations	1.144
200110	Cucumbers	1.664	220429	Grape wines	89.868
200210	Tomatoes	2.945	230990	Animals feed preparation	1.105
200290	Tomatoes nes	6.475	240120	Tobacco unmanufactured	14.262
200310	Mushrooms	2.477			
200510	Homogenized vegetables	17.019			
200520	Potatoes	43.467			

Source: Author's own estimates from WITS dataset

CHAPTER 2

Trade Liberalization and Food Security in Kenya

Prof. Tabitha Kiriti Nganga

2.1. Introduction

FAO (1999) reported that almost 800 million people in the developing world did not have enough to eat. Another 34 million people in the industrialized countries and countries in transition were also suffering from chronic food insecurity. FAO (2010) reported that a total of 925 million people were still estimated to be undernourished in 2010, representing almost 16 percent of the population of developing countries. The fact that nearly a billion people remain hungry even after the recent food and financial crises have largely passed indicates a deeper structural problem that gravely threatens the ability to achieve internationally agreed goals on hunger reduction: the first Millennium Development Goal (MDG) and the 1996 World Food Summit goal. The FAO (2010) report contends that economic growth, while essential, will not be sufficient in itself to eliminate hunger within an acceptable period of time.

FAO (2012) reports that about 870 million people are estimated to have been under-nourished (in terms of dietary energy supply) in the period 2010–12. This figure represents 12.5 percent of the global population, or one in eight people. The vast majority of these, 852 million, live in developing countries, where the prevalence of undernourishment is now estimated at 14.9 percent of the population. About a third of Kenya's population is considered to be food insecure (Republic of Kenya, 2008). Currently over 10 million people in Kenya suffer from chronic food insecurity and between two and four million people require emergency food assistance at any given time. Nearly 30% of Kenya's children are classified as undernourished, and micronutrient deficiencies are widespread (Republic of Kenya, 2008). Kenya is one of 15 countries most at risk of food

insecurity as measured by World Food Program Food Security Index. Kenya is ranked number 11 out of 163 with a food security score of 1.22.

The Global Hunger Index (GHI) estimated by Food Policy Research Institute (IFPRI) to measure and track global hunger does not have better news for Kenya either, as it ranks the country number 55 behind such countries as South Africa, Uganda, Congo DR and Malawi, among other countries in terms of global hunger index indicating a serious food security problem. The Republic of Kenya (2011) reports that in Kenya per capita food availability has declined by more than 10% over the last decade. The Policy paper says that food availability and access in Kenya are influenced by the ability of individuals and households to produce their own food in sufficient quantity and to generate income to purchase food, the adequacy of infrastructure, effectiveness of food distribution systems and the affordability of food prices. Other factors include access and control of productive resources (land, seed and water), governance, legal and regulatory frameworks, the macroeconomic environment, gender dynamics, HIV/AIDS and other diseases, emergencies and conflicts. From the foregoing, Kenya has a real problem in terms of food security and can be classified as one of those countries suffering from food insecurity. Article 43(1) (c) of the Constitution of Kenya (2010), guarantees food security to all Kenyans and this 'right to food' as presented in the Kenya constitution implies three obligations to governments: respecting, protecting and fulfilling that right meaning that it has to implement strategies that will guarantee food security to all Kenyans.

2.1.1. National Food and Nutrition Security Policy

The Republic of Kenya (2011) National food and nutrition security policy paper states that it *is the policy of the Government that all Kenyans, throughout their life-cycle enjoy at all times safe food in sufficient quantity and quality to satisfy their nutritional needs for optimal health.*

The broad objectives of the Food and Nutrition Security Policy (FNSP) are:

- To achieve good nutrition for optimum health of all Kenyans.
- To increase the quantity and quality of food available, accessible and affordable to all Kenyans at all times.

- To protect vulnerable populations using innovative and cost-effective safety nets linked to long-term development.

The FNSP addresses associated issues of chronic, poverty-based food insecurity and malnutrition, as well as the perpetuity of acute food insecurity and malnutrition associated with frequent and recurring emergencies, and the critical linkages thereof. These issues are:

Food availability and access: *The Government policy objective is to increase the quantity and quality of food available and accessible in order to ensure that all Kenyans have an adequate, diverse and healthy diet.*

Food safety, standards and quality control: *The Government policy objective is to ensure safe, high quality food by creating public awareness on relevant issues, and by setting, promoting and enforcing appropriate guidelines, standards and a regulatory framework.*

Nutrition improvement: *The Government policy objective is to achieve good nutrition for optimum health of all Kenyans. Enhancing food access, providing special nutrition interventions for specific vulnerable groups and creating awareness to provision of nutritious foods to all family members and especially children are among other major Government objectives.*

School nutrition and nutrition awareness: *The Government policy objective is to have all Kenyans knowledgeable about good basic nutrition required to live a healthy and active life, with clear and substantive roles for relevant government ministries, the media and other key stakeholders.*

Food security and nutrition information: *The Government policy objective is to build capacity and ensure the availability of quality and timely food and nutrition security data, information and analysis for better formulation and management of integrated food and nutrition security strategies, programs and action.*

Early warning and emergency management: *The Government policy objective is to protect vulnerable populations and address food insecurity concerns in developing capacity for purposes of early warning and emergency management using innovative and cost-effective safety nets and emergency relief programs linked to long-term development.*

Institutional and legal framework and financing: *The Government policy objective is to ensure an adequate institutional and legal framework, and to mobilize sufficient resources in order to achieve the objectives of the national Food and Nutrition Security Policy.*

The FNSP says that in Kenya, global fertilizer prices have been on the rise. With high fertilizer prices, majority of farmers already face serious constraints in terms of accessing these vital inputs, thus impacting negatively on the expected crop yields. Since the country mainly relies on the global market for its fertilizer supplies, both public and private sector interventions will be vital in cushioning farmers from high fertilizer prices.

There has been a gradual reduction in the levels of food stock, mainly cereals since the mid 90s. Global stock levels have been declining by 3.4 percent annually. This decline underscores the importance of supporting domestic production as well as diversification of food production and consumption.

It also states that imports of subsidized commodities pose unfair competition to local producers and markets. Non-strategic agricultural trade liberalization has resulted in many developing countries turning from being net food exporters to net food importers.

In Kenya, food availability has over time been understood in terms of cereal supply, and food security in terms of having enough maize. Per capita food availability has declined by more than 10 per cent over the last three decades, while per capita consumption of maize has increased by 3 per cent per annum. Most Kenyans still subsist on diets based on staple crops (mainly maize) that are lacking in nutritional diversity and have particularly devastating consequences on development of children. Food security in Kenya therefore encompasses availability of adequate quantities of a diversity of food commodities such as other cereals, fruits, vegetables and animal products.

Food availability and access in Kenya are influenced by the ability of individuals and households to produce their own food in sufficient quantity and to generate income to purchase food, the adequacy of infrastructure, effectiveness of food distribution systems and the affordability of food prices. Other factors include access and control of productive resources (land, seed and water), governance, legal and regulatory frameworks, the macroeconomic environment, gender dynamics, HIV/AIDS and other diseases, emergencies and conflicts.

High poverty levels in Kenya have affected household access to food. Most Kenyans rely on markets for some or all of their food needs. While most of the poor live in rural areas, the number in urban areas is rising fast. The strategy of the Government is to deliver the macroeconomic framework and incentives needed to address high food prices in a lasting

manner and the FNSP has emphasized employment creation as the most effective means of reducing poverty and improving access to food. Additional efforts to enhance food availability and affordability will focus on a sustainable increase in the production of food that is diversified and healthy, and expanding trade and market opportunities based on comparative and competitive advantages. Improved access will be achieved through enhancing rural and urban employment (economic access) and improving market systems (physical access) while safety nets for the vulnerable segment of the population will continue to be implemented and expanded.

2.1.2. Trade Liberalization in Kenya

Trade liberalization is the removal or reduction of barriers to trade that ensures free movement of goods and services from one nation to another. Kenya has had different trade regimes since independence. From Independence in 1963 to 1979, Kenya's main economic objective was to protect small industries in order for them to be able to compete in the global market. Hence after independence, Kenya's trade efforts were mainly guided by import substitution strategy. The Sessional Paper No. 10 of 1965 mainly centered on trade development and pursued enhanced protection of the domestic market to help develop industries. The Policy was a key influence on the development of trade regime in Kenya over the first decade from independence. The objectives of the Strategy were; rapid growth of trade, easing balance of payment pressure, increased domestic control of the economy and generation of employment.

Structural Adjustment Programs were introduced in the early 1980s to address the structural rigidities, price instability and macro-economic imbalances that had become embedded in the economy and led to poor delivery of services by the public sector. The main thrust of the adjustment programs was to produce a shift from a highly protected domestic market to a more competitive environment that would facilitate increased use of local resources, outward oriented policies that would promote employment creation and export expansion. The implementation of the Structural Adjustment Programs involved the promotion of non-traditional exports, liberalization of the market system and reform of international trade regulations.

In the 1990s, Kenya adopted export promotion strategies which proposed incentives that aimed at encouraging industries to provide for exports. When the NARC government came to power in 2002, it came up with Vision 2030 which is geared towards making Kenya a globally competitive and prosperous nation with high quality of life and to transform the economy from a supply constrained outfit responsive to enhanced domestic integration and wider participation in the global economy for national and international trade expansion. It is expected that food security can be achieved though the expansion of international trade.

2.2. Literature Review on Food Security

2.2.1. Theoretical Approaches to Food Security

The general approach to food security points out a number of environmental and socio-economic attributes assumed to explain famine and food security. The principal ones include: rapid population growth, war and civil strife, drought, ecological degradation, government mismanagement, unequal access to resources and unequal exchange, socio-economic and political dislocation (Getachew, 1995).

The approach argues that one or a combination of these can disrupt food production.

However, production failure may or may not result in famine or food insecurity. Due to this fact, the attributes (factors) are not precise explanations of the causation of the process of famine. It is in response to this major weakness that the specific approaches (models) of famine emerged (Degafa, 2002).

The food availability decline approach had been a dominant theoretical explanatory framework for food crises since the eighteenth century until the year 1980. Sen (1981) defined food availability decline as the availability decline per capita of food for a consuming unit. This approach conceived famine as shortages of food supplies per capita, motivated by natural factors, for example, drought, floods and other calamities that undermine crops; or demographic factors, that is, vegetative growth that goes beyond supply (Hewitt, 1993: cited in Diana, 2007). The central argument of this model is that anything which disrupts food production such as drought, flood or war can cause famine,

the logic being that a drought, flood or war causes crop failure and cattle death, reducing the availability of food in the affected region, and that such a food availability decline for an extended period by definition constituents of famine (Markos, 1997; Devereux, 1988: as cited in Degafa, 2002). Hence, this argument claimed that hunger and famine do not necessarily evolve from lack of food supplies in the market, but lack of resources in sectors to produce or purchase them. This criticism over food availability decline ended up in the alternative model of entitlement proposed by Sen in 1981.

The entitlement approach of Sen (1981) identifies four different ways that enable individuals to acquire food. They may produce it for themselves (production-based entitlement), and this can be affected by policies altering the demand and supply of factors used in production, some of which will relate to international trade.

They may sell or barter physical assets (trade-based entitlement). Agricultural producers can increase their own food production by exchanging either a surplus, a food or non-food product. However, the amount of food they can acquire can be influenced by policies that affect the level and variability of prices for food relative to what they are able to exchange.

They may sell their labor power (labor-based entitlement). Rural landless laborers and urban employees all need to buy or barter food in the market. Their food security is determined by the level and location of employment opportunities which, in turn, may be altered by trade policy.

They may receive informal gifts from individuals and formal transfers from government (transfer-based entitlement). These are important for those lacking other adequate means. Formal transfers such as food aid or cash transfers may be influenced by multilateral trade agreements.

Famine occurs when a large number of people suffer a complete collapse in their exchange entitlements. Important though Sen's work is, it has its limitations. First, the entitlement approach views famines and other food-related emergencies as economic disasters. However, as Sen himself pointed out, his approach concentrates on rights within

the given legal structure in that society, but some transfers are illegal acts, and therefore not accommodated by the entitlement approach nor can they be measured easily (Sen, 1981).

Entitlement theory has been criticized on two further counts. First, it implies a straightforward sequence of entitlement failure leading to hunger and then to malnutrition, starvation and death. Second, it implies that people's actions are largely determined by their need to consume food (de Waal, 1990). But research into people's responses to famine, mostly referred to as coping strategies, has shown that their priorities in times of food stress are to preserve productive assets to protect livelihoods, rather than to meet immediate food needs (Corbett, 1988).

A livelihoods approach to food-security assessments (mainly used by OXFAM) considers both the severity of food insecurity (in terms of people's ability to feed themselves and the impact on nutritional status), and the processes that generate food insecurity (vulnerability, risk and coping), and that have a long-term impact on livelihoods.

In a livelihoods approach, the severity of food insecurity is gauged by its impact on people's ability to feed themselves in the short term (risk to lives), and its impact on livelihoods and self-sufficiency in the longer term (risks to livelihoods). These two perspectives allow the severity of food insecurity to be judged. A population or livelihood group is considered acutely food insecure if people experience a large reduction in their

major source of food and are unable to make up the difference through new strategies; the prevalence of malnutrition is abnormally high for the time of year, and this cannot be accounted for by either health or care factors; a large proportion of the population or group is using marginal or unsustainable coping strategies; and people are using coping' strategies that are damaging their livelihoods in the longer term, or incur some other unacceptable cost, such as acting illegally or immorally.

2.2.2. Empirical Literature Review

Mwaniki (2005) discusses the main causes of food insecurity in developing countries and some of them include unstable social and political environments that preclude sustainable

economic growth, war and civil strive, macro-economic imbalances in trade, natural resource constraints, poor human resource base, gender inequality, inadequate education, poor health, natural disasters, such as floods and locust infestation, and the absence of good governance. All these factors contribute to either insufficient national food availability or insufficient access to food by households and individuals.

A study by Boussard et al. (2005) found that 99 per cent of the food in Sub-Saharan Africa is grown under rain fed agriculture. Hence, food production is vulnerable to adverse weather conditions. Other causes of food insecurity include rapid population growth, limited access to agriculture-related technical assistance, underdeveloped agricultural sector and lack of knowledge about profitable soil fertility management practices leading to expansion in to less-favorable lands. Barriers to market are also causes of food insecurity in Africa (Mwaniki, 2005; FAO, 2005). Some barriers of market access are poor infrastructure, market standards, limited information, and requirements for large initial capital investments, limited product differentiation, and handicapping policies.

Alex (2003) found that diseases such as malaria, tuberculosis and mainly HIV/AIDS not only reduce the man hours available to agriculture and household food acquisition, but also increase the burden of households in acquiring food.

A study conducted in a Lesotho village found that women and children suffered from lack of food and hygiene because women were too exhausted to cook and clean at times of peak agricultural work (Huss-Ashmore: cited in Driba, 1995 and Degafa, 2002).

Haswell (1953) observed that growing cash crops at the expense of subsistence crops has largely contributed to seasonal food deficiency among the Gernieri in Gambia. The author also observed that illness of adults at critical times in the production process adversely affects labour efficiency and productivity, which in turn contributes to seasonal food shortage.

Trade and trade policies influence both world food availability, as well as production and food imports (including food aid) at the national level. But trade and trade policies may also have an impact on the rate and variability of growth, as well as its quality (i.e. the

employment, income distribution, and poverty effects). Dollar and Kraay (2000); Winters (2000); World Bank 2000 and Morley (2000) in their works show the relationship between different trade policies, economic growth, income distribution and poverty. Through trade, governments increase their revenues through collection of trade taxes and these revenues can have an impact on food security through social protection programs such as cash transfers and food subsidies.

According to Kiio (2011), globally, markets and trade are important in promoting food availability, access, stability and calorific consumption in most regions of the world. Trade ensures food distribution from surplus to deficit areas. Trade contributes to the four pillars of food security: Food availability pillar through purchase of inputs and distribution; food access pillar through prices and distribution; food stability through storage and food utilization through distribution and ensuring quality of the food.

Trade is critical in bridging the consumption gap caused by structural deficiency in the production. Trade in agricultural contributes to stabilizing supply when national fluctuations (on the lower side) in production are greater than the fluctuations in any region. Trade partly substitutes for working stocks if the harvesting calendar differs among trading partners. Trade also allows countries to specialize in production in accordance with comparative advantage.

Barrett (1999) explored the empirical relationship between U.S. food aid flows per capita and non-concessional food availability per capita in recipient economies. The author found that while perhaps modestly progressive in its distribution, food aid fails to stabilize food availability in recipient economies. Both increased domestic food production and commercial trade appear more effective than food aid in increasing and stabilizing food availability per capita in low income economies.

Houser and Rosenberg-Carlson (2012) used a historical case study methodology to examine the role that neoliberal policy reforms have played in the state of food security in Kenya. They found that food security had decreased over the period after the neoliberal reforms, and that the agricultural tactics adopted to cope with this food insecurity after the reforms had caused land degradation which would only lead to more food insecurity.

Sasson (2012) contends that the major cause of food insecurity is inadequate food production and the soaring food prices and food riots are among the many symptoms of the prevailing food crisis and insecurity in Africa. The author recommends that it is necessary that international donors fulfil their commitment to help African farmers and rural communities and protect them against unfair trade, competition, and dumping of cheap agri-food products from overseas.

Omollo (2012) found that that the urban poorest are the most vulnerable when it comes to opening up the market to international trade and recommends that the government should put in extra efforts on initiatives that can bring the urban poorest out of poverty and also ensure that they are less vulnerable to shock such as trade liberalization. The author also found that the impact of trade liberalization on poverty and households welfare was positive though quite small implying that trade liberalization alone is not sufficient to improve welfare and recommends a combination of other policies that improve economic performance in ensuring that trade liberalization results in poverty reduction and development.

OECD (2012) found that market reforms benefit countries that were competitive in the export market, but has discouraged farmers in many African countries where agriculture was not competitive. This makes these countries to now rely even more on food imports than liberalization and hence these countries are more susceptible to food price increases on the global market. Hence according to OECD (2012), the reduction of trade barriers combined with the abrupt abandonment of government support to the agricultural sector discourages domestic food production in several African countries. The study found that gradual market reform, in combination with support to farmers, local market development or improved land security, has had significant positive results for countries such as Burkina Faso and Vietnam.

Countries that accumulate big external debts are in danger of food security since export earnings are used to service the external debt instead of being ploughed back to increase domestic production.

Kore Pwodiksyon Lokal[1] (2008) reported that the influx of food and resources from the United States, Canada and Europe severely undermined the Haitian economy and agriculture systems and that, liberal trade agreements had crushed Haiti's agriculture sectors and had significantly contributed to unemployment and rural-urban migration. Haiti's local agricultural economies had virtually collapsed and could barely produce 48 per cent of the food consumed in the country. However, Haiti's attempts to rebuild her social and economic infrastructure had been undermined by required debt repayments.

Chiweta (2012) estimated the relationship between food aid and domestic food availability and found that the responsiveness of domestic food availability to food aid inflows in the short term was elastic implying that an increase in food aid inflows would influence an increase in the level of food availability in the short term but in the long term the author found that food aid discourages domestic food production and hence a decrease in food availability in the country.

2.2.3. Conceptual Framework

National food security exists when all people, at all times, have physical, social and economic access to sufficient, safe and nutritious food that meets their dietary needs and food preferences for an active and healthy life. Household food security is the application of this concept to the family level, with individuals within households as the focus of concern. Food insecurity exists when people do not have adequate physical, social or economic access to food as defined above. Undernourishment exists when caloric intake is below the minimum dietary energy requirement (MDER). The MDER is the amount of energy needed for light activity and to maintain a minimum acceptable weight for attained height. It varies by country and from year to year depending on the gender and age structure of the population. Millennium Development Goal 1, target 1(c) is to halve, between 1990 and 2015, the proportion of people who suffer from hunger (World Food Summit, 1996; FAO, 2010).

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[1] Kore Pwodiksyon Lokal is a Haitian Organization motivated by a desire to increase support for Haitian farmers and producers. Our goal is spread the word about the benefits and joys of eating locally and to build the capacity of Haitian farmers and producers.

As mentioned before, food security, at the individual, household, national, regional, and global levels is achieved when all people, at all times, have physical, social, and economic access to sufficient, safe, and nutritious food to meet their dietary needs and food preferences for a healthy and active life (FAO, 2001).

Food security not only requires an adequate supply of food but also entails *availability, access,* and *utilization* by all—men and women of all ages, ethnicities, religions, and socioeconomic levels. Conceptually, food security has four pillars of availability, accessibility and utilization (FAO, 2001). Household food access depends on a combination of families' own food production, income, food prices, and household buffers (money, food storage capacity) to bridge food shortage periods, for example between harvests(OECD, 2012). Food availability is the amount of food that actually exists which could be from local production and other sources. An individual can acquire food in different ways and these ways can be affected either directly or indirectly by policy changes. Food availability, at the local or national level, is a condition but no guarantee for food access, as households may not be able to afford or access needed food. At the national level, food availability is the sum of domestic food production, food imports, food stocks and international food aid, minus food exports. Export earnings allow food import. Natural resource management, land tenure security, and financial services also support household to maintain their productive capital (OECD, 2012).

Oxfam defines food security as when everyone has at all times access to and control over sufficient quantities of good quality food for an active healthy life. Within this definition, the two elements of food security are availability (the quality and quantity of the food supply); and access (entitlement to food through purchases, exchange and claims).

A country can achieve food self-sufficiency through enough domestic production or achieve self-reliance through the ability to purchase (importation) enough food all the time. Trade in food commodities between states plays a key role in achieving food security. The following quote is attributed to Pascal Lammy, the former WTO Director General while emphasizing the role of trade in food security.
"But we must ask ourselves why there is such wide spread resentment to trade opening, if such opening is indeed vital to global food security. To me the answer is clear. It is because we

have yet to build robust safety-nets for the world's poor. Each and every government must turn its attention to this issue, urgently, in my view. In the absence of such safety nets, there will always be resentment at a time of crisis to a country's food supply going abroad." **Pascal Lammy WTO Director General (2011)**

Agriculture remains the largest employment sector in most developing countries and international agriculture agreements are crucial to a country's food security. Some critics argue that trade liberalization may reduce a country's food security by reducing agricultural employment levels. Concern about this has led a group of World Trade Organization (WTO) member states to recommend that current negotiations on agricultural agreements allow developing countries to re-evaluate and raise tariffs on key products to protect national food security and employment. They argue that WTO agreements, by pushing for the liberalization of crucial markets, are threatening the food security of whole communities. The question is whether food insecurity both at the household and national levels can be alleviated through domestic and international trade.

Figure 2.1 shows a conceptual framework of food security through trade.
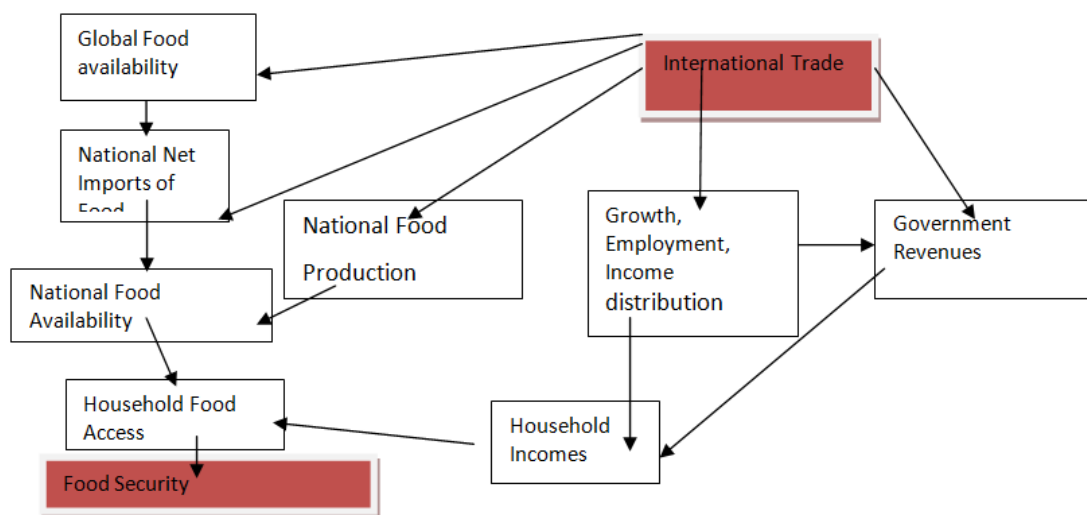
Figure 2.1: Conceptual Framework of Achieving Food Security through International Trade
Adapted from Smith, L. C. (1998)

Food security refers to availability of a country's population of an adequate and reliable supply of food. This can involve a number of elements: increasing local food production; improving the stability of food supplies and lastly, guaranteeing access to food supplies (through either purchasing power or compensatory mechanisms (CARE, 1988).

Food security is linked with food self sufficiency and is measured by the ability of the household to secure its need for staple food. Food security depends on availability of cash which will enable a household to purchase staple food and basic factors of production such as labor (Calon, 1990).

Ensuring food security entails meeting two conditions: that there is adequate food supplies available and that people have the ability to acquire food by means of their own production or by means of income. Food availability therefore does not refer solely to food self-sufficiency but is linked to incomes and purchasing power (World Bank,

1988).

One of the ways of ensuring food security in terms of availability in a country is through trade which could be domestic trade or international trade. A country can also achieve food security through increased import requirements although for some countries the availability of foreign exchange can be a major constraint which can limit the role of imports in filling the shortfall between production and consumption and this may be due to low commodity prices which may limit export earning potential. Also changes in world markets, such as world food price stability and world food price levels can also affect a country's ability to meet food availability shortfall. These affect both the ability to finance imports via export earnings and changes in the food import bill, themselves potential indicators of changes in the food security situation.

This study analyses the role of international trade and other factors in determining food security in Kenya.

2.3. Methodology

The amount of food available to feed a country's residents can come from one of various sources: domestic production, food aid and commercial imports from abroad. However, food availability can be affected by the level of openness[2] of a country, the rate of inflation, the share of aid to GDP that a country receives the share of foreign debt to GDP and so on.

In this study we assume that aggregate food availability is dependent on domestic production (represented by grain production); commercial imports; food aid; share of Aid to GDP; Inflation rate; openness; (exports + imports/GDP); and share of foreign debt to GDP.

We can therefore estimate the amount of food availability using the following model:

Food availability = f(domestic production, commercial imports, food aid, share of aid to GDP, inflation rate, openness, share of foreign debt to GDP)………………………..(1)

$$lnAFAV = \alpha_0 + \alpha_1 lnCI + \alpha_2 lnFA + \alpha_3 lnSIGDP + \alpha_4 lnOPNESS + \alpha_5 SFDGDP + \alpha_6 lnDP + \alpha_7 lnIFR + e \ldots\ldots\ldots\ldots\ldots\ldots\ldots(2)$$

where lnAFAV stands for log of aggregate food availability; lnCI is the log of commercial imports; lnFA shows the log of food aid; lnSIGDP is the log of the share of aid to GDP; lnOPNESS stands for log of openness (export + exports/GDP), SFDGDP is the share of foreign debt to GDP, lnIFR is the log of the inflation rate and lnDP stands for the log of domestic production. Ln shows that the variables have been converted into their natural

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[2] The *trade-to-GDP ratio* is frequently used to measure the importance of international transactions relative to domestic transactions. This indicator is calculated for each country as the simple average (*i.e.* the mean) of total trade (*i.e.* the sum of exports and imports of goods and services) relative to GDP. This ratio is often called the trade openness ratio, although the term "openness" may be somewhat misleading, since a low ratio does not necessarily imply high (tariff or non-tariff) barriers to foreign trade, but may be due to -factors such as size of the economy and geographic remoteness from potential trading partners (http://www.oecd-ilibrary.org). However, Squalli and Wilson (2011)
have come up with a composite trade share measure that more completely reflects reality by combining two important dimensions of trade openness: trade share and the relative importance of a country's trade level to total world trade. This study uses the OECD measure.

logs while $\alpha_1 \ldots \alpha_6$ are parameters to be estimated and e shows the error term. The logs of the variables were stationary at levels and there was no multicollinearity. The errors were homoscedastic and serially uncorrelated making the OLS estimators optimal.

Food security can also be estimated by looking at the prevalence of food inadequacy or the prevalence of undernourishment but estimated model 2 using the log of food availability as the dependent variable.

2.3.1. Definition of Variables

Openness to trade refers to the degree to which countries or economies permit or have trade with other countries or economies. The trading activities include import and export, foreign direct investments, borrowing and lending and repatriation of funds abroad. In this study, it was measured as a summation of exports and imports as a percentage of GDP. In our study this is an indicator of liberalization.

Inflation is defined as the rise in the general prices of goods and services in an economy over a period of time. This indicates the overall ability of individuals to access food. Low inflation would make it easy for consumers to afford food purchases while high inflation would make it hard for them to afford food.

Domestic production is the production of food (mainly cereals) in Kenya for use in the country.

Food Aid stands for all food supported interventions aimed at improving the food security of poor people in the short and long term funded via international resources.

Share of aid to GDP is the Official Development Assistance (ODA) received as a per cent of Gross Domestic Product.

Commercial Imports stands for the quantity of food in order to maintain the historical levels of national average per capita supplies. This may not necessarily be a very good indicator of food security since a country gets exposed in international price shocks.

Share of foreign Debt to GDP is the stock of resources borrowed externally by the government of Kenya as a share of GDP. Countries that accumulate big external debts are in danger of food security since export earnings are used to service the external debt instead of being ploughed back to increase domestic production.

This study uses time series data from secondary sources such as FAO website.

2.3.2. Time Series Properties

Stationarity

Using non-stationary series could yield spurious results. It is for this reason that this study conducted stationarity tests for the series. The stationarity tests on the variables were done using the Augmented Dickey Fuller (ADF) and the Phillips-Peron (PP) tests. The ADF assumes that the error terms are independently and identically distributed. The PP test is non-parametric and corrects the statistic to conduct for autocorrelation and heteroskedasticity (Gujarat, 2004).

A time series data is said to be stationary if its mean, variance and autocovariance remain the same no matter at what point we measure them. The ADF is a higher level of the Dickey Fuller (DF) test. The DF test involves the estimation of the regression equation   as shown in equation 3.

$Y_t = \alpha + \rho Y_{t-1} + e_t$ ……………………………………………………………….. (3)

where α and ρ are parameters and e_t are white noise. Y is stationary if $-1 < \rho < 1$. If $\rho=1$, Y is non-stationary. If the absolute value is greater that 1 ($\rho>1$), the series is explosive. Subtracting Y_{t-1} from both sides of equation (3), the DF equation of estimation becomes what is shown in equation (4).

$\Delta Y_t = \alpha + \lambda Y_{t-1} + e_t$ ……………………………………………………………… (4)

where $\lambda = \rho\text{-}1$.

The null hypotheses are: $H_0: \lambda = 0 \text{ and } H_1: \lambda>1$.

The assumption of the DF test is that the errors terms are uncorrelated, homoscedastic as well as identically and independently distributed (iid).

The ADF corrects the higher order serial correlation by adding lagged differences on the right hand side. Thus

$$\Delta Y_t = \alpha + \lambda Y_{t-1} + \sum \delta_i \, Y_{t-1} + e_t \ \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots \ (5)$$

The specification is then tested for $H_0: \lambda = 0$ and $H_1: \lambda > 1$.

In equation (4), e_t is 1(0) and may be heteroskedastic. The Phillips-Peron (PP) unit root test corrects for any serial correlation and heterskedasticity in the errors e_t non-parametically by modifying the Dickey Fuller series.

Thus the PP test involves fitting the regression as shown in equation (6).

$$y_i = \alpha + \rho y_{t-1} + e_t \ \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots \ (6)$$

and the null hypothesis is $\rho = 0$ against the alternative that $\rho \neq 0$. The advantage of the PP test over the ADF test is that the PP tests are robust to general forms of heteroskedasticity in the error term e_t. The second advantage is that the user does not have to specify a lag length for the test regression.

2.3.3. Data Analysis

The objective of this study was to investigate whether trade is one of the determinants of food security in Kenya among other determinants. The study used food availability as a proxy for food security because food has got to be available before it can be accessed, utilized or even for it to be sustainable. Other determinants considered were domestic production (represented by grain production); commercial imports; food aid; share of Aid to GDP; Inflation rate; openness; (exports + imports/GDP); and share of foreign debt to GDP.

The study used OLS to estimate equation 2 and the variables were estimated in their log forms. Table 2.5 gives a key for the shortened variables.

Table 2.5: Key for Shortened Variables

LNAFAV	Log of Aggregate food availability
LNFA	lnFA shows the log of food aid
LNCI	lnCI is the log of commercial imports
LNSIGDP	log of the share of aid to GDP
LNOPNESS	lnOPNESS stands for log of openness (export + exports/GDP)
LNSFDGDP	SFDGDP is the share of foreign debt to GDP
LNDP	lnDP stands for the log of domestic production
LNIFR	lnIFR is the log of the inflation rate

2.4. Empirical Results

2.4.1. Normality Tests and Descriptive Statistics

The diagnostic tests on the model were done to test for its statistical soundness. It is a requirement that for a classical linear model, the error term be normally distributed with a zero mean and constant variance (Gujarat, 2004).

Similarly, the residuals should be free of heterskedasticity and autocorrelation.

The normality test was also done. This test is done to ensure that the variables used in the analysis are normally distributed. The common test for normality is the Jarque–Bera statistics test (Jarque, 1980). This test utilizes the mean based coefficient of skewness and kurtosis to check the normality of all the variables used. A common rule-of-thumb test for normality is to run descriptive statistics to get skewness and kurtosis, and then divide these by the standard errors. Normality test uses the null hypothesis of normality against the alternative hypothesis of non-normality. If the probability value is less than the Jacque Bera chi-square at the 5% level of significance, the null hypothesis of the regression is not rejected. A sufficiently low probability value of the estimated jarque-bera chi-square statistics leads to acceptance of the null hypothesis of a normal distribution. Table 2.6 shows the descriptive statistics and the normality test results. From table 2.6, all the variables are normally distributed since all the probabilities are less than the Jarque Bera chi-square distribution of 0.05, the normality assumption of the residuals could not be rejected and therefore the regression results followed a normal distribution.

Table 2.6: Descriptive Statistics in Logarithms and Normality Test

	LNAFAV	LNCI	LNFA	LNSIGDP	LNOPNESS	LNSFDGDP	LNDP	LNIFR
Mean	8.722755	6.518111	5.029509	1.654561	4.084725	3.905731	14.359372	2.388454
Median	8.936167	6.624065	5.165846	1.386294	4.043051	3.879202	14.338877	2.397895
Maximum	9.234057	7.794411	6.091310	2.772589	4.290459	4.817354	14.699046	3.850148
Minimum	8.001690	4.912655	3.465736	0.693147	3.871201	3.224333	13.966735	0.741937
Std. Dev.	0.414961	0.661095	0.776984	0.555019	0.122956	0.472822	0.200398	0.778786
Skewness	-0.357421	-0.428059	-0.455661	0.560473	0.155808	0.267019	-0.290598	-0.291791
Kurtosis	1.451686	3.320913	2.026782	2.439331	2.062855	2.051361	2.351227	2.869285
Jarque-Bera	2.544741	0.731434	1.481384	1.374509	0.853428	1.036973	0.663859	0.312947
Probability	0.280167	0.693699	0.476784	0.502955	0.652650	0.595421	0.717538	0.855154
Observations	21	21	20	21	21	21	21	21

2.4.2. Unit Roots Test for Stationarity Results

The unit root test was used to test for stationarity. Augmented Dickey Fuller Test was used to test for stationarity. The unit root test indicates whether the variables are stationary or not. The null hypothesis is that of non-stationarity while the alternative hypothesis is that of stationarity. The regression software automatically prints the t –statistic testing. The t statistic is then compared with t critical. If t-statistic is less than t-critical reject the null hypothesis of non-stationary and therefore the series is stationary. On the other hand if is t-statistic is more than t-critical accept the null hypothesis of non-stationary and therefore the series is stationary (Green, 2003). This is shown in Table 2.7.

Table 2.7: Unit Root Test using ADF at Levels

VARIABLE	ADF STATISTIC	5% CRIRICAL VALUE	NATURE
LNAFAV	-0.846233	-3.6591	NON-STATIONARY
LNCI	-2.251077	-3.6591	NON-STATIONARY
LNFA	-2.034309	-3.6591	NON-STATIONARY
LNSIGDP	-1.478774	-3.6591	NON-STATIONARY
LNOPNESS	-2.030544	-3.6591	NON-STATIONARY
LNSFDGDP	-2.604873	-3.6591	NON-STATIONARY
LNDP	-1.776878	-3.6591	NON-STATIONARY
LNIFR	-3.140385	-3.6591	NON-STATIONARY

From the table 2.7, all the variables are non stationary at levels because the ADF t-statistic is greater than the ADF t-critical at 5% level of significance. We therefore differenced the variables to make them stationary and the results are shown in Table 2.8.

Table 2.8: Unit Root Test using ADF after Differencing

VARIABLE	ADF STATISTIC	5% CRIRICAL VALUE	NATURE
dLNAFAV	-6.835875	-3.6920	STATIONARY
dLNCI	-12.15257	-3.6920	STATIONARY
dLNFA	-4.893569	-3.6920	STATIONARY
dLNSIGDP	-8.210736	-3.6920	STATIONARY
dLNOPNESS	-7.140912	-3.6920	STATIONARY
dLNSFDGDP	-6.941867	-3.6920	STATIONARY
dLNDP	-10.13751	-3.6920	STATIONARY
dLNIFR	-6.589151	-3.6920	STATIONARY

The variables were then differenced and subjected to the same tests. The results of the differenced ones are presented in the table 2.7. The results from table 2.8 show that the ADF t- statistics are less than the t-critical and therefore we reject the null hypothesis of non-stationary and accept that the series are stationary. The first differencing of all variables is therefore stationary which implies that these variables are integrated of order one I(1).

Given the fact that the variables in logs were stationary, there was no need to conduct a co-integration test. This also implied that the classical OLS regression could be conducted since the results would not be spurious. The Results of the regression analysis are shown in table 2.9.

Table 2.9: Regression Analysis with Natural Log of Food Availability as the Dependent Variable

Variable	Coefficient	Standard Error	t-statistic	Probability
CONSTANT	0.042484	0.042503	0.999560	0.3468
LNCI	-0.444910	0.197643	-2.251077	0.0371
LNFA	-0.381924	0.187742	-2.034309	0.0578
LNSIGDP	-0.235699	0.159388	-1.478774	0.1575
LNOPNESS	0.396141	0.195091	2.030544	0.0582
LNSFDGDP	-0.521513	0.200207	-2.604873	0.0185
LNDP	1.455359	0.214754	6.776878	0.0000
LNIFR	-0.747608	0.238062	-3.140385	0.0060
R-SQUARED	0.600459			
ADJUSTED R-SQUARED	0.200918			

2.4.3. Discussion of Results

From Table 2.8, it can be seen that the coefficient for commercial imports of food is negative showing that increased commercial imports lead to a reduction in food availability and this result is statistically significant at the 5% level. This is unexpected as

one would expect that increase in commercial imports would lead to increased food availability. However, the results could be explained by the fact that there can be increased commercial imports but the people's purchasing power may be minimal or the distribution of the said imports may be hampered by poor infrastructure or the said imports may be those that only cater for the urban areas or a certain category of the population.

Food aid also contributes negatively to food availability as shown by the negative coefficient and this result is also statistically significant at the 10% level of confidence. This results accords with those of Kore Pwodiksyon Lokal (2008) who found that the influx of food and resources from the United States, Canada and Europe in the form of food aid severely undermined the Haitian economy and agriculture systems hence contributing to unemployment and rural-urban migration. The results also conform to those of Barrett (1999) who found that food aid flows from the US to recipient countries failed to stabilize food availability in these countries. The results also confirm those of Chiweta (2012) who after estimating the relationship between food aid and domestic food availability, found that the responsiveness of domestic food availability to food aid inflows in the short term was elastic implying that an increase in food aid inflows would influence an increase in the level of food availability in the short term but in the long term the author found that food aid discourage domestic food production and hence a decrease in food availability in the country.

However, openness (trade in exports and imports) is positively related to availability of food and this variable is also significant at the 10% level of confidence which accords to the findings of Dollar and Kraay (2000); Winters (2000); World Bank (2000) and Morley (2000). This means that trade liberalization through removal of barriers to trade increases food availability and reduces food insecurity since barriers to market are causes of food insecurity in Africa as found by Mwaniki (2005) and FAO (2005). Through trade, governments increase their revenues through collection of trade taxes and these revenues can have an impact on food security through social protection programs such as cash transfers and food subsidies. Our findings also conform to those of Kiio (2011) who contends that globally, markets and trade are important in promoting food availability,

access, stability and calorific consumption. The author argues that trade ensures food distribution from surplus to deficit areas and that in terms of food availability it facilitates the purchase of inputs and distribution of food and allows a country to exploit its comparative advantage.

On the other hand, the share of foreign debt to GDP is negatively related to availability of food and this is also statistically significant at 5% level. These accords with our earlier hypothesis that countries that accumulate big external debts are in danger of food security since export earnings are used to service the external debt instead of being ploughed back to increase domestic production.

Domestic production of food is positively relate to availability of food and this is statistically significant at the 1% level of confidence while inflation is also statistically significant at the 1% level indicating that an increase in inflation leads to loss of purchasing power and hence a decrease in the amount of food available to the people. These findings accord with those of Sasson (2012) who contends that the major cause of food insecurity is inadequate food production and the soaring food prices.

2.5. Conclusion and Policy Recommendations

From the study findings both increased domestic food production and openness appear more effective than food aid, inflation, foreign debt and commercial imports in increasing and stabilizing food availability in Kenya. It is therefore important for the Government of Kenya to come up with policies to increase domestic food production. The Government needs to pursue participatory and sustainable food, agriculture, fisheries, forestry and rural development policies and practices in high and low potential areas. These policies are essential in order to maintain and sustain adequate and reliable food supplies at the household and national levels. Such policies should be ones geared on intensification and streamlining of agricultural research; promotion and training of agricultural extension officers; irrigation, improved supply of inputs such as seeds and fertilizers, agricultural credit; mechanization; land reform; improvement of infrastructure such as roads, railway network, energy, water supply; markets and storage facilities and so on. This would lead to an increase in domestic production of food and reduce reliance on food aid.

Policies geared towards removal of barriers to trade at the regional level should be fast tracked to enhance trade not only among the African countries but also with the rest of the world. Some barriers to trade include poor infrastructure, market standards, limited information, and requirements for large initial capital investments, limited product differentiation, and some rules and regulations that become non tariff barriers to trade especially in their implementation.

The study has also found that inflation leads to a reduction in food availability. The government therefore needs to come up with policies to stabilize prices. Such policies would involve formation of stabilization funds (to prevent the constant fluctuations of prices), buffer stocks (to stabilize food supplies); or the increase in strategic food reserves. The Government can also come up with subsidies scheme on farm inputs such as on seeds and fertilizers.

The Government can also adopt policies to promote economic growth and provide social protection for vulnerable households. This can be done through strengthening social protection systems, improving emergency preparedness and investing in sustainable small scale agriculture.

The Government also needs to come up with methods to reduce the foreign debt or a sound debt management policy. This would include a sound macroeconomic policy that would be geared towards stabilization of interest rates, exchange rates; and inflation. It would also be aimed at increasing Kenya's domestic revenue base; proper and prudent budgeting and making sure that government expenditure is on productive sectors.

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CHAPTER 3

Export Duration and Determinants of Exports Survival in Kenya

Bethuel Kinyanjui Kinuthia

3.1. Introduction

This paper examines the duration of exports as well as the determinants of exports survival in Kenya. Within trade literature export growth can be decomposed into three parts namely establishing new partners and markets, having relationships survive and persist and deepening the existing relationships. Creation of new export relationship commonly referred to as the extensive margin is the motivation behind many trade promotion policies, while export survival and deepening are important dimensions of intensive margin. According to Besedes and Prusa (2011) developing countries are argued to be particularly poor on intensive margins in that they are unable to maintain and deepen their export relationships. By contrast, developing countries perform better on the extensive margin and often establish more relationships than do developed countries. However, low survival is not necessarily a sign of welfare loss if it reflects strong experimentation at the extensive margin, but it can be inefficient if sunk costs of entry and exit are substantial (Das et al. 2007).

Until recently, the issue of trade duration was largely ignored in trade literature. Most trade models implicitly assumed that trade will persist once established. However, empirical literature has shown that trading relationships especially for developing countries suggest short lived trade spells. For example, Besedes and Prusa (2007) found that within the manufacturing sector of 46 countries, the median survival period is just 1-2 years. Likewise, Cadot et al. (2011) found that only one out of five new export relationships from Malawi, Mali, Senegal and Tanzania survive the first year. In addition, Mohammed (2012) found a median duration of 5-6 years for Ghanaian manufacturing exporters. Prolonged export relationships are important for two reasons. Firstly, it is a sure way of increasing exports of existing products with existing trade partners (Fugazza & Molina, 2009). Secondly, it results in efficiency gains for the exporting firms since such firms have a better

chance of learning from exporting. Such gains in efficiency are likely to have positive implications for aggregate export performance and industrial growth.

This study seeks to contribute to this new literature by examining exports data on products in Kenya. To undertake this task, the study will pursue two objectives. First is to examine the export duration of Kenyan exports. The second objective is to examine the determinants of exports survival beyond the first year in Kenya. The Key contributions of this pioneering paper on export duration and survival in Kenya are threefold. First, I will document for Kenya a set of stylized facts on export survival that is broadly consistent with emerging firm-level literature, so far confined to mainly countries within the OECD or middle income countries and recently in a few African countries. Secondly, I provide evidence of a key outcome of interest, namely survival beyond the first year after entry into exports markets and finally identify the determinants of export survival which are largely unknown.

From a policy perspective this paper will be important in several ways. First, the domestic market in Kenya is fairly small and therefore Kenya's long held desired industrialization can only be possible through the export route. Secondly, the findings from this paper will be useful in contributing to a possible rationale for using public funds to promote national exports abroad. In addition, this will break new ground which is more useful in assisting policy makers and other stakeholders in not only analysing export issues but also in accelerating export growth and sustainability. Finally, this paper also identifies new area for policy focus from the traditional emphasis on export diversification and market access initiatives towards export sustainability.

The rest of the paper is structured as follows. Section two below discusses in brief the export sector in Kenya, followed by a review of literature on export survival in section three. Section four presents the analytical framework, while the fifth section presents a brief description of the data. The empirical results are presented in section six and the conclusions in section seven.

3.2. Overview of Kenya's Exports Sector

Figure 1 below presents the evolution of Kenya's trade balance and export growth. Exports as a share of GDP have been on decline though moderate from above 30 percent

in 1961 to slightly below 30 percent in 2012. There was a notable decline during the structural adjustment period in the 1980s. There was significant increase in this share in the early 1990s when trade was fully liberalize but a further decline there-after. The growth in exports has been irregular over the years with most of the period experiencing an annual growth of less than 10 percent per annum. In some years, this growth has been negative especially during the oil crisis periods in the 1970s, severe draught and rains in the 1990s as well as during the recent financial crisis. Kenya has only experienced a surplus in the trade balance during the period around its independence in 1963 and a brief moment in the early 1990s. For the rest of the period, it has experienced a deficit in its trade balance which has been widening since 1995.
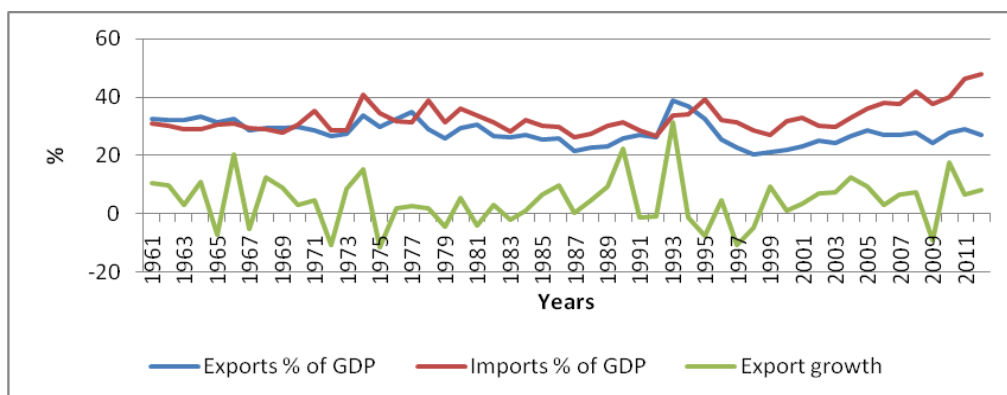
Figure 3.2: Trade balance and export growth in Kenya (1961-2012)
 Source: World Development Indicators (World Bank database, 2013)

The manufacturing sector in particular has performed poorly during this period. While Kenya inherited a relatively well established manufacturing sector at independence in 1963, the sector's overall performance has been rather dismal. The share of the manufacturing sector in GDP has changed little over the last three decades. From figure 3.3 below, this share has remained at approximately 12 per cent for the period 1976-2010. In addition, the manufacturing value addition annual growth has equally been disappointing much of it oscillating between 3 and 5 per cent. The growth of the Kenyan economy has also been low, largely depending on the agricultural sector and services. However, since the 1990s there was been a surge in the manufacturing exports due to the

liberalization of the Kenyan economy. However, this was short lived and manufactured exports declined until 2002 when a new Government was formed in Kenya.

The limited growth of this sector can be traced to many factors such as the poor implementation of the import substitution strategy, discouraged learning, and most of the firms were inefficient and could not compete internationally. In the 1980s Kenya began pursuing Structural Adjustment Programmes aimed at the removal of government involvement in the productive sector, orientation of the manufacturing sector towards exports, and liberalization of the economy. However, these efforts did not yield much success, and the manufacturing sector experienced limited transformation. Towards the end of the 1990s, Kenya established export processing zones and other export plat forms aimed at attracting foreign firms to produce manufactured goods for exports. The enactment of AGOA in the United States was boon to textile exports from Kenya. At the same time, there were various pieces of legislation aimed at supporting small and medium enterprises, in anticipation of linkages arising from their interaction with the foreign-owned firms. By 2008, although the share of consumer goods had reduced, there was increased involvement in the production of cement and chemicals and other minerals, and the manufacturing sector had yet to undergo significant transformation.
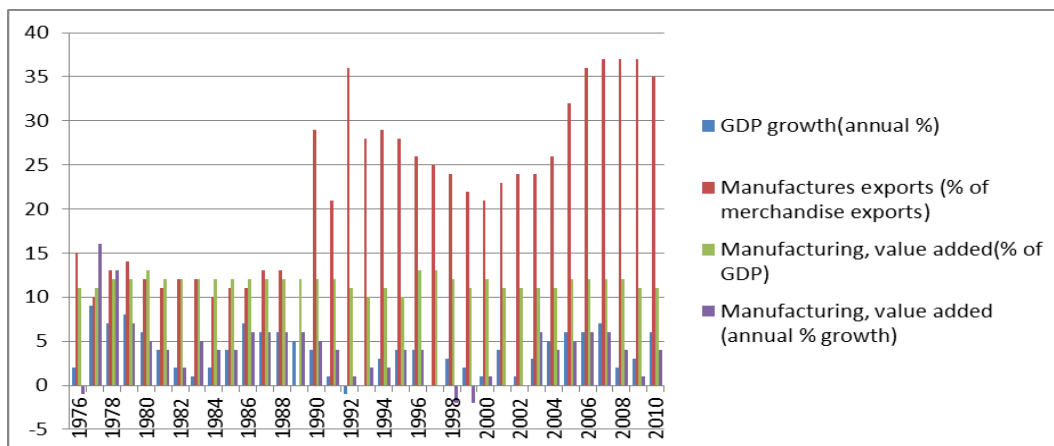
Figure 3.3: Selected Indicators of the manufacturing sector in Kenya (1976-2010)
Source: World Bank Database, 2010

3.3. Literature Review on Export Survival

Recent literature on international trade has suggested that maintaining and prolonging export relationships, after they have been created, is an important condition for export success. The main theoretical contribution on export survival is associated with Rauch and Watson (2003) who explored the duration of trade relationships through a search model. They studied the creation of an evolution of partnerships between buyers in developed countries and suppliers in less developed countries. Their model preceded in three stages namely search, investment or deepening, and rematch or abandoning the existing relationships in search for other suppliers. In their framework, buyers' i.e importers started with small purchases because of the uncertainty surrounding the suppliers. Orders increased only if the seller delivered and complied with the clients' expectations. The model predicted that the length of a trade relationship is positively correlated with the initial amount of the transaction, and that the propensity to start low value transactions increases with the cost of search and decreases with reliability.

Several studies have tested the main predictions of this theoretical work. Beginning with Besedes and Prusa (2006) who used two panels of U.S. imports, one spanning 1972-1988 with tariff schedule data and the other spanning the 1989-2001 periods with 10 digit data. In both cases, they found that half of all the trade relationships lasted only one year and three quarters lasted three years or less. Once censoring was taken into account, median duration was two years. Most strikingly, this pattern of short duration was robust to aggregation at HS6, even though one would expect interruptions to be smoothed out by aggregation. They also found negative duration dependence, meaning the hazard rate fell as the export spells grew older. In terms of survival determinants the study found that industrial country exports lasted longer, and so did export of machinery. Finally, they found that the hazard rate was 23 % higher for homogenous products than for differentiated ones, although initial transactions were 40% to 350% larger, confirming the predictions of the Rauch and Watson (2003) theoretical model. Other empirical studies which have followed a similar approach have tended to confirm these early findings[3].

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[3] See Besedes(2008), Besedes and Prusa(2007) and Nitsch (2008).

While all these studies emphasise on the role of the type of product and of trade values in determining the duration of trade relationships, they ignore the role of fixed costs whether the latter are sunk or paid in each period in order to operate in foreign markets. More recent studies which incorporate the role of fixed cost include that by Fugazza and Molina (2011). Using an extended Cox model, they evaluate the effects of the country and product characteristics, as well as of trade costs on the duration of trade relationships from 96 countries for the 1995-2004 period. They found that the duration of trade relationships increases with the region level of development. Trade relationships from richer countries face lower hazard rates i.e longer duration. They also found that trade relationships involving differentiated products show hazard rate that is 6% to 14% lower than trade relationships involving homogenous products. In addition, they found that high export costs systematically increase the probability of export failure but the effect diminished with time, thus suggesting that export experience plays a role. Finally, they found that the size of export matters i.e the larger the transaction, the higher the probability of survival.

Likewise Cadot et al. (2011) using dataset with transaction level exports data from four African countries (Mali, Malawi, Senegal and Tanzania) found that survival probability rises with the number of firms exporting the same product to the same destination from the same country, pointing towards the existence of cross-firm synergies, which are believed to emanate from information spillovers. They also find that firms that are more diversified in terms of products, but even more in terms of market, are more likely to be successful and survive beyond the first year. Similarly, Kamuganga (2012) examined the effects of intra-regional cooperation on the sustainability of Africa's exports within Africa and the rest of the world for the period 1995-2005. The study found little impact of regional trade cooperation in enhancing Africa's export survival. In addition, factors such as the cost to exports, transit delays, procedure to export, financial depth and institutional and policy biases were all found to increase the probability of Africa's exports failure. Furthermore, the study found that African export trade relationships have a very short life, with the median duration of exporting a product just 1 year and average length of 2.08 years.

Mohammed (2011) using data on exporting firms within the manufacturing sector in Ghana for the period 1991-1998, found their median duration was between 5-6 years. In addition, the study found that the longer a firm remains exporting, the greater the likelihood of survival in exporting. Other factors such as firm age, size, and export intensity each enhance the probability of firms surviving in export markets while exporting a final product reduces the probability of survival. Within Latin America, Besedes and Blyde (2010) found that 48 % of the export relationships survive the first year, 19 % survive 5 years and only 15 % survive by the end of 15 years. They also found that the hazard rate of exporting increases with distance between partners, the ad-valorem transport costs and with the elasticity of demand on the goods traded. At the same time partners that are large in size, share a common boarder language and have a free trade agreement tend to exhibit lower hazard rates. In addition, the initial size of the export value is associated with a higher probability of survival and that depreciated exchange rates increase the odds of export survival. Finally, they find that exporting countries with more developed financial systems and with institutions that support contract enforceability tend to maintain their export relationship longer.

Similarly, Carrere and Khan (2012) using product level at the SITC 5 digit level for the period 1962-2009 for developing countries exporting to the OECD, have shown that prior export experience obtained in non OECD markets, increases survival in OECD markets. The effect of experience depreciates however rapidly with time and they show that gaining experience for more than two years is worthless. In addition they find that a break in export experience prior to entering the OECD reduces the benefit on survival. Geographical export dynamics in this study reveal that experience is acquired in neighbouring, easy to access market before reaching more distant, richer partners and ultimately serving the OECD. Preferential trade agreements (PTAs) among developing countries are found to help exporters in finding partners from whom to learn about their export potential. Finally the study found that the exporters may acquire experience directly within the OECD market through trial and error. By facilitating this process, PTAs between developing countries and OECD help boost survival in the long run.

3.4. Analytical Framework

There are two basic techniques used in survival analysis well discussed by Brenton et al. (2012:33). The object of interest in the survival analysis is the length of spells and the identification of the factors that make the spell end. The survival analysis is useful in focusing on the long term sustainability of trade relations rather than year to year changes in trade volumes, and to examine the relationship between the survival time and covariates i.e factors that may influence the survival. Outside the laboratory experiment, because the sample period is not infinite, some spells will be "left censored" (that is already active when the sample period starts) or "right censored" (that is, they will not be completed when the sample period ends). Left censored spells are typically dropped out from the sample, whereas right censored spells are treated explicitly by the econometric procedures of the survival analysis.

In this study, two survival models will be used. First, I use the Kaplan-Meier survival function to examine the general patterns of the survival of exports in Kenya. The survival function gives the probability of trade relationship such as exporting, surviving past a given time t. Second, I use the extended Cox Proportional Hazard model to examine the degree of influence of the trade agreements on export survival while controlling for other effects of other independent variables.

The Kaplan-Meier non parametric estimator, sometimes called the product limit estimator, approximates the survival function defined as follows. Let T be the duration of a given export spell (a random variable) and t be a particular arbitrary value of T. The survivor function is the probability that takes place at or after t- that is survival is at least T:

$$S(t) = \Pr(T \geq t) = 1 - F(t)$$

(1)

where F(t) is the cumulative distribution function at the failure time.

Consider now several spells, and let i be an index of time going from the beginning of the spell to their death. That is, suppose we observe a sample of N spells whose duration varies between 1 and 10. Then $i = 1\ldots\ldots 10$. Let k be the number of spells that die

exactly at i years and n_i be the number of spells that are still alive after i years. The Kaplan-Meier estimate of $S(t)$ is

$$\dot{S}(t) = \prod_{i=1}^{t}(1 - \frac{k_i}{n_i})$$

(2)

The ratio in the parenthesis is the ratio of spells dying to spell at risk; thus, it is a discrete-time equivalent of the hazard rate. The Kaplan-Meier estimate of the survivor function in the first year is the proportion of spells that do not die in the first year. Its estimate in the second year is the product of that by the proportion of spells that do not die in the second year (among those still alive) and so on.

Cox regressions explain hazard rates (death/termination probabilities) in terms of individual covariates, under particular assumptions. The hazard rate of a distribution is the probability that an event (here, death) occurs in the next instant, given that it has not happened yet. Formally

$$h(t) = \lim_{\Delta t \to 0} \Pr\ (T \leq t + \Delta t | T \geq t) = \frac{f(t)}{1-F(t)} = \frac{f(t)}{S(t)}$$

(3)

In the continuous time case, it can be interpreted as the risk of an event to happen (instantaneous rate of occurrence), while in discrete time case it is simply seen as the conditional probability that the event will occur at time t, given that it has not occurred before. There is a large family of survival models that can be used for continuous and discrete time cases. I use the semi-parametric Cox (1972) model. This type of model has the advantage that it does not require the specification of the distribution of the duration dependency and it is therefore appropriate to assess the impact of explanatory variables on the hazard rate. The hazard rate in the Cox model is given by:

$$h_i(t) = h_0(t)e^{\beta' x_i}$$

(4)

where $h_0(t)$ is the baseline hazard function, which represents the risk at time *t* when $x_i(t) = 0$. In the Cox model, the baseline hazard function is assumed to be unknown and left unparametarized, x_i is a vector of covariates representing the characteristics of individual *I*, β is a vector of coefficients, accounting for the effects of those characteristics. By taking the natural logarithm, the additive log-linear model can be estimated as follows.

$$log\left(\frac{h_i(t)}{h_0(t)}\right) = \beta'x_i$$

(5)

A Cox regression is estimated using maximum likelihood. Parameter estimates for the, $\beta's$ give partial correlations between each of the covariates and the hazard rate; thus a positive coefficient indicates that the particular covariate raises the probability of termination and therefore contributes negatively to survival. Coefficients can also be reported as hazard ratios that is, exponentiated coefficients. An exponentiated coefficient above one indicates that a covariate raises the hazard rate. In this analysis an extended version of the Cox model that relaxes the proportionality hypothesis by including time dependent covariates and time interactions terms is used.

3.5. Data considerations and Description of Variables

This study uses product level data (HS 6 digit level bilateral trade flows) for the period 1995 to 2010. The dataset contains a total of 186,122 observations being exports from Kenya to 221 countries in the world. The unit of analysis is product Kenya exports to other countries based on the COMTRADE database, where the data were obtained. Additional data for other variables used in this study are obtained from the World Development Indicators (WDI) of 2013. Table A3.15 in the appendix presents the summary statistics of variables which are presented in table 3.10 below and discussed in detail thereafter.

Table 3.10: Variable Description and Data Sources

Variable	Description	Source
Trade Flows	HS 6 digit level for 1995-2010	COMTRADE database (2013)
Cost to export	USD per container	WDI (2013)
Time to Export	No of days taken to export	WDI (2013)
Cost of doing business	Cost of business start-up procedure (% of GNI per capita)	WDI (2013)
Connectivity index	Liner shipping connectivity index	WDI (2013)
Financial Depth	Domestic Credit to the Private sector (% of GDP)	WDI (2013)
FDI inflows	Net inflows (BOP, current USD)	WDI (2013)
Exchange rate	Official exchange rate (LCU per US$, period average)	WDI (2013)
Tariff line	Share of tariff lines with international peaks, all products (%)	WDI (2013)
Tariff rate	Applied, simple mean, all products (%)	WDI (2013)
Institution	broad dimensions of governance: Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, Control of Corruption	World Bank, Kaufmann et al. (2013)
EAC	A binary variable that equals one if the trading partner is a member of the East Africa Community (EAC)	Author's construction
COMESA	A binary variable that equals one if the trading partner is a member of the Common Market for East and Southern Africa (COMESA)	Author's construction
GDP	Real GDP for partner countries	WDI (2013)

The first set of variables is aimed at examining the importance of infrastructure related to trade costs. In this category five variables are considered. First the cost of exports, which captures all the fees associated with the completing procedures for exports. These include costs for documents, administrative fees for customs clearance, technical control, custom brokers' fees, terminal handling charges e.t.c officially reported. Second, the time taken to export, which is expressed in terms of recorded calendar days. The procedure for its calculation starts from the moment it is initiated and runs until exporting activity is completed. The third variable is the cost of doing business, which considers the cost associated with business registration, normalized by presenting it as a percentage of gross national income (GNI) per product. The last variable in this category is the Connectivity index. The Liner shipping connectivity index measures the how well a country is connected to the global shipping network. It is computed by the United Nations Conference on Trade

and Development (UNCTAD) based on five components of the maritime transport sector: number of ships, their container-carrying capacity, maximum vessel size, number of services, and number of companies that deploy container ships in a country's ports. The more severe the infrastructure variables the less likely for export sustainability, hence a negative relationship is expected between export survival and the set of variables.

The second set of variables is related to policy shocks. In this category three variables are considered, the exchange rate, foreign direct investment inflows and financial depth. Unexpected, appreciation in the exchange rate are expected to positively the affect the hazard rate of Kenyan exports. A rise of FDI inflows in the Kenya, may affect the hazard rate of Kenya's exports negatively especially if it invests in the export sector, while the development of the financial sector measured in terms of credit expansion into the private sector, is also expected to reduce the hazard rate.

The third set of variables focuses on market access. Two variables are considered, first the tariff line which is measured in terms of share of tariff lines with international peaks. It is the share of tariff lines in the tariff schedule with tariff rates that exceed 15 percent. It provides an indication of how tariffs are selectively applied. The second variable is the tariff rate which is a simple mean applied tariff is the unweighted average of effectively applied rates for all products subject to tariffs calculated for all traded goods. Data are classified using the Harmonized System of trade at the six- or eight-digit level. These two variables are related. It is expected that high tariff rates will have a positive effect on the hazard rate.

The fourth set of variables is related to institutions. It is based on the worldwide governance indicators project which constructs an aggregate of indicators six broad measures of governance broad dimensions of governance: Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption based on the Kauffmann et al. (2010) Governance indicators. This study considers governance index based on Percentile rank among all countries which ranges from 0 (lowest) to 100 (highest) rank. It is hard to predict the influence of this variable on the export survival but it is assumed that better governed countries will have higher export survivals, hence lower hazard rates. Finally, I

introduce regional dimensions. In particular the study focuses on how membership to the EAC and COMESA can affect the export survival. It expected that increased trading within these regions is likely to lower the hazard rate of Kenya's exports. The real GDP of the countries is also included. It is expected that high GDP lowers the hazard rate due to increased likelihood of sustained trade.

The product data is summarised using a histogram in figure 3.4 below. The figure shows variation in the export trade values to the rest of the world. The export value of most products does not exceed the USD 50,000 mark for the entire period under consideration. Along the same lines Kamuganga (2012) observed that all African trade relationships fall below the mark of USD 100,000 at product level. In this regard, Kenya would be an exception since close to 13 percent of Kenya's exports value exceeds this mark. Figure 3.5 below, shows the survival probability over time for the Kenyan exports to the EAC and the rest of the world. It shows that the probability of death of exports relationship is high in the first years of the export relationship discovery but decreases over time. There is no survival completely at the end of the sample period[4]. It has been shown that relative to other regions; only 2 percent of African export relationships survive to the 10th year. In Kenya, close to 20 percent of the export relationships survive after the first year but decreases steadily over time. Few export relationships exceed the 13th period. This is much lower than the African average of 36 percent of initiated export relationships. The survival rate is higher for exports within the region both EAC and COMESA compared to the rest of the world (figure 3.5 and 3.6 below).

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[4] However, this is largely due to the restricted sample period and not necessary due to ending an existing export relationship.
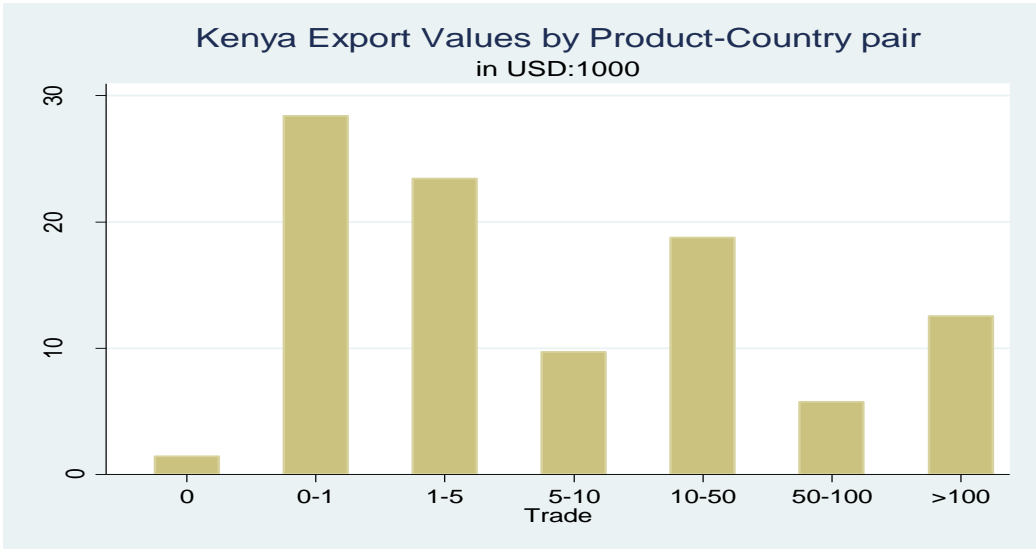
Figure 3.4: Histogram for Kenya's export values

Note: The histogram shows the distribution of positive export observations. Almost 2 percent of potential export flows at product level in Kenya's export matrix are "Zero flows". Export values are reported in 1000s of USD. This implies that 98 percent of Kenya's bilateral export relationships are positive trade flows. Also only 13 percent of Kenya's export relationships fall below the mark of USD: 100,000 at product level.
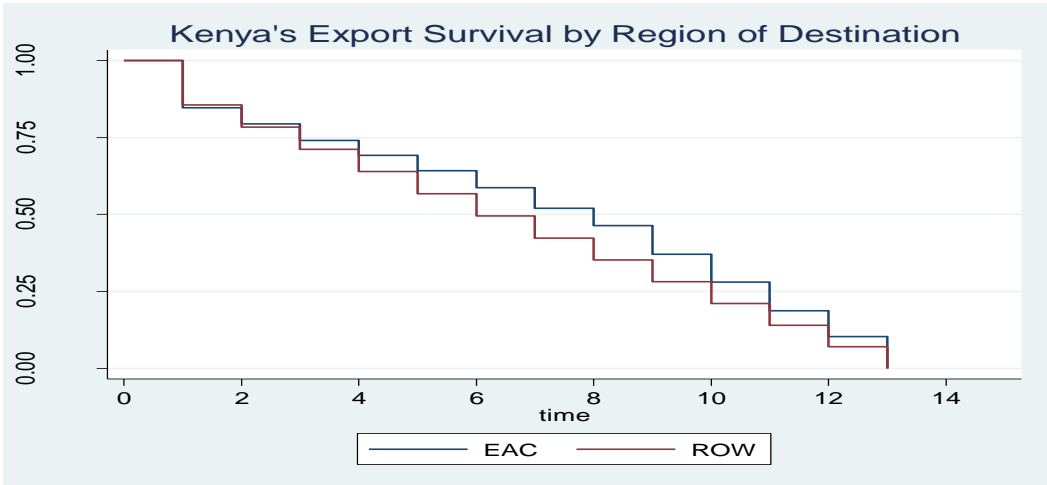
Figure 3.5: Export Survival for all Kenyan Products (EAC vs the Rest of the World)
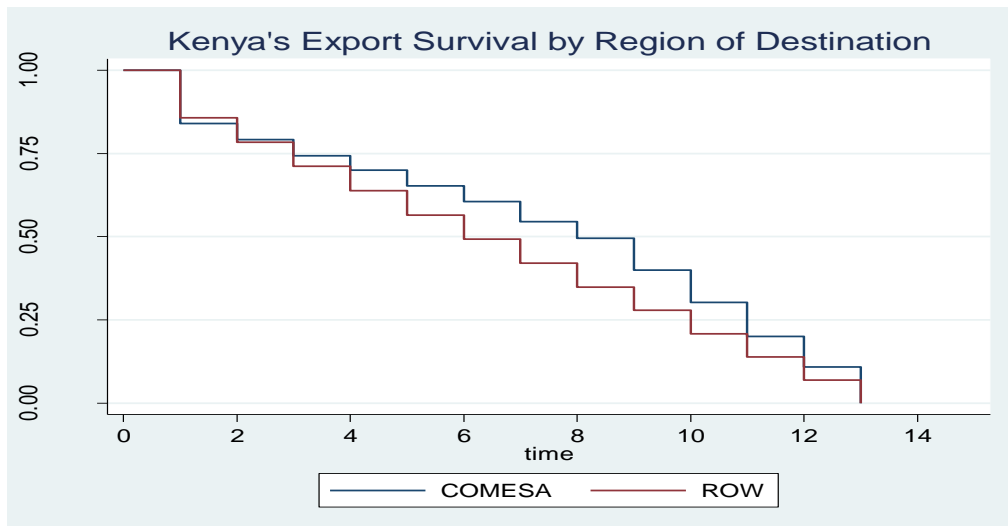
Figure 3.6: Export Survival for all Kenyan Products (COMESA vs the Rest of the World)

Figure 3.5 and 3.6 above also show that the probability of death of export relationship is high in the first one year but decreases over time. This is much lower than for the rest of Africa where the death rate is estimated to be high the first 5 years, but decreases over time (Cadot et al. 2011). The results obtained suggest that while Kenya's export relationships may have a short duration, it is much higher than what many studies find for other countries. Besedes and Prusa (2006), Fuggaza and Molina (2009) and Kamuganga (2012) have shown that short duration of trade may be explained by the small value of many trade transactions. In addition, prolonged duration of export relationship is important not only for increasing export relationships with trading partners but also for increasing the efficiency of exporting firms.

From the analysis above, it can be noted that Kenya's export relationships last longer when it exports to other African countries within the region (EAC and COMESA) compared to the rest of the world. Second, on average about 20 percent of Kenya's export survive after the first year and this relationship decreases steadily over time and this is much lower than the Africa average of 36 percent. Just up to 10 percent of Kenya's exports last up to 13 years. Hence, in the next section the study investigates the factors that are likely to

explain the low export survival in Kenya. This is done econometrically based on the Stratified Cox Proportional Hazard Model (1972).

In this estimation the results are likely to be affected by at least four econometric problems. First, arises due to endogenity with some of the explanatory variables. To overcome this problem, fixed effects estimation at exporter-product market level, is used (Kamuganga 2012 and Baier and Bergstrand, 2007). Second, given the unit of analysis used in the study namely exporter-product-market level (idd), the structure of the errors may not be homoscedastic. To correct this problem of heteroscedastic errors, clustered standard errors at the idd level are used in all the specifications. Finally, using a continuous time proportional hazard model to evaluate the determinants of export survival in Kenya may result in some misspecification due to the presence of unobserved heterogeneity. This problem is overcome by the use of stratified proportional hazards variant model, stratified at exporter-product-market level. In addition, an exporter-product-market fixed effects that takes in to account the potential unobserved heterogeneity of export data at the product level is used.

3.6. Empirical Results

Table 3.7 below presents the first set of results which is based on the estimation of the effects of infrastructure related trade costs and regional membership on export survival. As the table shows the coefficients of regional membership to the EAC and COMESA are not statistically significant in all the specifications. This would imply that regional trade cooperation does not reduce the probability of failure of Kenya's export relationships-reduces hazard rates for Kenya's exports. However, from figure 3.2 and 3.3 above, exports survival to these two regions is much higher than to the rest of the world. This may suggest that Kenya is yet to realise the full benefits presented by regional cooperation through exports. This result is in consistent with that obtained by Kamuganga (2012) who found that regional trade cooperation in Africa except through Preferential Trade Areas (PTA) increases its export survival.

The infrastructure variables related to trade costs are all significant at the 1 percent level in all the specifications even with inclusion of other variables in tables 3.11 to 3.13. The

time to export variable carries a positive sign in most of the specifications. This implies that increased time to export increases the hazard rates of Kenya's exports. The cost of export and cost of doing business variables have alternating signs in all the specifications, hence not robust. It can be concluded that these costs have the potential of reducing export survival of Kenya's exports if they remain unchecked. The liners shipping connectivity index is negative and significant at the 1 percent level in all specifications. Hence, increased connectedness of Kenya to the global shipping networks has a positive effect on Kenya's export survival.

Table 3.11: Effects of Regional Trade and Infrastructure related trade costs on Export Survival

Dep var: Hazard Rate	1	2	3	4	5
EAC	0.023	-4.49E-11	4.74E-08	-3.1E-10	1.98E-07
	(0.016)	(0.006)	(0.006)	(0.008)	(0.006)
COMESA	0.006	5.59E-12	-1.4E-08	1.01E-10	-5.87E-08
	(0.005)	(0.003)	(0.004)	(0.005)	(0.004)
Cost to Export		-2.944***	2.326***	3.2774***	-6.340***
		(0.103)	(0.857)	(0.319)	(0.158)
Time to Export			2.067***	2.348***	2.267***
			(0.062)	(0.352)	(0.028)
Cost of doing Business				3.719***	-1.902***
				(0.227)	(0.05)
Shipping Index					1.394***
					(0.004)
Observations	2605708	1116732	1116732	1116732	1116732
Level of Significance		*** P<0.01			

Note: The dependent variable is the hazard rate. The unit of observation is Kenya's export product to each country. A positive sign on the coefficient signifies an increase in the probability of an export relationship failure (increase in hazard rate). Asterisks indicate level of statistical significance: *** significance at 1%.

Table 3.12 below presents the specification of the effects of policy shocks on export survival. According to this table development of financial depth and increased foreign

direct investment inflows are negative and significant at the 1 percent level and hence reduce Kenya's hazard rate, while exchange rate fluctuations increase the hazard rate. Hence macroeconomic development matters for export survival. Positive macroeconomic development in Kenya enhances export survival. These results are not consistent with those obtained by Kamuganga (2012) who found a positive and significant relationship between financial depth and foreign direct investment inflows on export survival. However, the study also found that exchange rate decreases export survival in Africa, consistent with our results. Fugazza and Molinna (2009) obtained similar results.

The impact of market access on export survival is presented in table 3.13 below. From the table the tariff line for Kenya appears to encourage export survival, which is negative and significant at the 1 percent level. However, the impact of the tariff rate on the hazard rate is positive and significant at the 1 percent level. This suggests that the tariff rate matters for export survival in Kenya. A high tariff rate of Kenya's products reduces their export survival rates.

Table 3.12: Effects of Policy Shocks on Export Survival.

Dep var: Hazard Rate	1	2	3
EAC	-4.56E-06	7.45E-08	-2.19E-08
	(0.007)	(0.006)	(0.006)
COMESA	1.09E-06	-2.23E-08	6.55E-09
	(0.004)	(0.004)	(0.004)
Cost to Export	3.043***	-3.541***	-3.435***
	(0.112)	(0.210)	(0.273)
Time to Export	1.053***	1.317***	1.880***
	(0.008)	(0.009)	(0.011)
Cost of doing Business	1.414***	-2.625***	-1.717***
	(0.026)	(0.042)	(0.081)
Shipping Index	-3.953***	0.458***	-0.149***
	(0.001)	(0.003)	(0.002)
Financial Depth	-1.177***		
	(0.023)		
FDI inflows		-0.990***	
		(0.002)	
Exchange rate			0.303***

			(0.001)
Observation		1116732	1116732	1116732
Level of Significance		*** P<0.01	

Note: The dependent variable is the hazard rate. The unit of observation is Kenya's export product to each country. A positive sign on the coefficient signifies an increase in the probability of an export relationship failure (increase in hazard rate). Asterisks indicate level of statistical significance: *** significance at 1%.

Table 3.13: Effects of Market Access on Export Survival.

Dep var: Hazard Rate	1	2
EAC	7.84E-05	-7.33E-11
	(0.007)	(0.007)
COMESA	-2.25E-05	2.88E-11
	(0.004)	(0.021)
Cost to Export	-2.218***	-1.684***
	(0.127)	(0.021)
Time to Export	-3.205***	6.795***
	(0.042)	(0.010)
Cost of doing Business	2.171***	-0.028***
	(0.075)	(0.027)
Shipping Index	-1.023***	-2.799***
	(0.010)	(0.001)
Tariff line	-1.333***	
	(0.017)	
Tariff rate		1.652***
		(0.032)
Observation	1116732	1116732
Level of Significance	*** P<0.01	

Note: The dependent variable is the hazard rate. The unit of observation is Kenya's export product to each country. A positive sign on the coefficient signifies an increase in the probability of an export relationship failure (increase in hazard rate). Asterisks indicate level of statistical significance: *** significance at 1%.

Finally, table 3.15 below presents the impact of governance indicators on export survival in Kenya. From this table, all the governance indicators are negative and significant at the 1 percent level except the corruption variable. This shows the importance of institutions in export survival in Kenya.

Table 3.14: Effects of governance on Export Survival

Dep var: Hazard Rate	1	2	3	4	5
EAC	3.09E-10	-1.2E-11	2.18E-05	3.46E-09	-8.69E-06
	(0.007)	(0.006)	(0.007)	(0.007)	(0.007)
COMESA	-1.5E-10	3.14E-12	-6.5E-06	-9.82E-10	2.83E-06
	(0.004)	(0.004)	(0.004)	(0.004)	(0.004)
Cost to Export	-1.261***	0.256***	-1.438***	0.834***	-2.357***
	(0.081)	(0.125)	(0.102)	(0.092)	(0.087)
Time to Export	1.255***	-1.929***	1.768***	-3.394***	2.941***
	(0.006)	(0.017)	(0.007)	(0.032)	(0.007)
Cost of doing Business	-1.908***	2.874***	-2.939***	2.446***	2.736***
	(0.014)	(0.043)	(0.028)	(0.235)	(0.024)
Shipping Index	-3.732***	-3.236***	-0.622***	-2.819***	-4.287***
	(0.002)	(0.003)	(0.002)	(0.014)	(0.001)
Voice and Accountability	-0.478				
	(0.000)***				
Political Stability		-0.652***			
		(0.001)			
Government Effectiveness			-0.432***		
			(0.000)		
Rule of Law				-1.898***	
				(0.011)	
Control of Corruption					1.216***
					(0.001)
Observation	1116732	1116732	1116732	1116732	1116732
Level of Significance	*** $P<0.01$				

Note: The dependent variable is the hazard rate. The unit of observation is Kenya's export product to each country. A positive sign on the coefficient signifies an increase in the probability of an export relationship failure (increase in hazard rate). Stars indicate level of statistical significance: *** significance at 1%.

However, the results also seem to suggest that attempts at the control of corruption by government authorities affect export survival in Kenya. In this study this corruption variable reflects perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. It may be that the manner in which corruption is controlled is problematic and likely to discourage exporters.

3.7. Conclusion

In this study, the duration of Kenya's export was investigated as well as the underlying determinants of export survival. The results on export duration show that on average less than 20 percent of Kenya's export survive after the 2nd year and this relationship decreases steadily over time. Just up to 10 percent of Kenya's exports last up to 13 years. In addition, Kenya's export relationships last longer when it exports to other African countries within the region (EAC and COMESA) compared to the rest of the world.

On the determinants of export survival the study obtained the following key results. First, at present, Kenya's membership and trade relationship with members within the regional groupings specifically the East Africa Community countries and the Common Market for Southern and East African countries, has not translated into higher export survival. While there are some gains from trading with these countries, these gains are not large enough to guarantee export survival. This is consistent with the evidence of low intra Africa trade. The second result shows that infrastructure related to trade costs and in particular the time taken to export and the connectedness to the global shipping networks affect the export survival. Longer delays to export and limited connectedness reduce export survival in Kenya. Third, the results show that macroeconomic management matters for export survival. In particular, increased financial development, large FDI inflows and better management of the exchange rate have a positive effect of Kenya's export survival. Fourth, increased market access especially through reduction in tariffs has a positive effect on export survival just as important as good governance is. However, controlled corruption appears to decrease export survival.

The key policy recommendations emanating from this study are as follows. First to increase export survival in Kenya there is need to encourage attempts towards deeper regional integration. Second, macroeconomic stabilization is crucial for increased export survival. Attracting FDI inflows has the potential of increasing export survival in Kenya. There is need to consider reducing time taken to export as it affects the ability of Kenya's export to survive. Greater openness in particular removal of tariffs increases export survival. Improved governance is important for an increase in export survival.

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Table A3.15: Summary of Statistics of Key Explanatory Variables

	Cost of Export	Financial Depth	FDI inflows	Exchange Rate	Tariff Lines	Tariff Rate	Time to Export	Burden of Customs Procedure
Mean	2010.84	28.05	137.62	73.25	37.35	13.49	30.53	3.27
Maximum	2055.00	33.83	729.04	79.23	41.69	19.44	45.00	3.35
Minimum	1955.00	24.60	5.30	58.73	34.29	12.07	26.00	3.15
Median	2055.00	26.93	81.74	75.55	37.39	12.27	29.00	3.28
Standard Deviation	46.69	2.65	197.80	5.98	1.62	2.48	6.26	0.07
Skewness	-0.16	0.89	2.47	-1.00	1.04	1.55	1.78	-0.64
Kurtosis	1.11	2.91	7.65	3.09	4.75	3.66	4.44	2.18

	Cost of Business Start-up	Liner Shipping Connectivity Index	Voice & Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
Mean	46.81	10.85	34.98	13.57	33.45	45.30	18.69	17.48
Maximum	54.90	13.09	43.80	19.20	38.80	50.20	23.40	22.40
Minimum	39.60	8.59	20.70	9.50	28.30	35.30	13.90	12.20
Median	46.00	10.85	39.40	13.20	34.10	47.50	18.70	18.00
Standard Deviation	4.26	1.67	8.15	2.59	2.68	4.94	2.70	2.95
Skewness	0.35	0.12	-0.75	0.14	-0.08	-1.13	0.03	-0.10
Kurtosis	2.86	1.51	1.86	2.19	2.23	2.73	1.71	1.93

Note: The units of analysis for the variables are described in table 1 above.

CHAPTER 4

Does Foreign Direct Investment Enhance Economic Growth? Analysis of Kenyan Data

Daniel O Abala

4.1. Introduction

4.1.1. Backrgound

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 (a non-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 has grown enormously in the last three decades. For example prior to the recent economic crisis, global FDI has risen to US $ 1,833 billion in 2007 well above the US $ 1,748 billion in 2000(UNCTAD, 2008). The production of goods and services by multinational corporations and their foreign affiliates have continued to rise as evidenced by increase in FDI from US $ 15 trillion in 2007 US $ 18 trillion in 2010 (UNCTAD 2010). The increase in FDI has been singled out as the most important factor for poverty reduction (Rose and Mwega, 2006). Most developing countries such as Kenya are interested in FDI a source of capital for industrialisation. This is because FDI involves a long term commitment to the host country and contributes significantly to the gross fixed capital formation.

FDI has been identified to contribute significantly to the economic growth of 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 FDI into their economies due to the perceived benefits associated with FDI inflows. It has been suggested in numerous papers that foreign firms are able to positively affect the levels of productivity and growth rates in the industries they enter and to also promote skill upgrading, increase employment and increased innovation (Blomström, 1986; Blomström and Persson, 1983; Görg and Strobl, 2001; UNCTAD, 2005). However, it has also been argued that FDI may lower or replace domestic savings and investment, transfer low level or inappropriate technologies for the host country's factor proportions target primarily the host country's domestic market and even inhibit the expansion of indigenous firms thereby limiting growth. By focusing solely on local cheap labour and raw materials, foreign firms may not be helpful in developing the host country's dynamic comparative advantages (UNCTAD, 2005). Nevertheless, the negative consequences of FDI can be managed with proper business and labour regulation (Rose and Mwega, 2006; Kinuthia 2010).

There are at least three major types of FDIs. The market-seeking FDI usually serves local and regional market and involves the replication of production facilities in the host countries. A variant of this type of FDI is also known as Tariff-jumping or export-substitution FDI and it is driven mainly by market size and market growth of the host economy. Due to market and income considerations FDIs in small and poor countries are unlikely to be of the market seeking type (see Lim 2001; Campos and Kinoshita, 2003 and UNCTAD, 1998).

The resource or asset-seeking FDI is another type of FDI and involves the relocation of parts of the production chain to the host country. This is usually driven by the availability of low-cost labour and is often export-oriented. This type of FDI is also attracted to countries with abundant natural resources such as oil and gas.

The third type of FDI is the efficiency-seeking type where the firms gain from common governance of geographically dispersed activities in the presence of economies of scale and scope. The idea here is to take advantage of special

features such as labour costs, skills of the labour force and quality of infrastructure. We next examine the evolution of FDI flows in Kenya and how it has affected economic growth in Kenya.

The hope of vision 2030 has apparently not been fulfilled and Kenya's share in the regional market, both in EAC and the wider COMESA is still less than 15%. However, it still appears that the economic growth of a developing country may well depend on among other things on an opportunity to make profitable investments and accumulate capital. It is similarly true that one of the ways of achieving this objective is through the attraction of foreign capital and investments which allows a country to exploit opportunities that would otherwise not be available (OECD, 2002).

4.1.1.1. Evolution of FDI and Kenya's Economic Growth

Kenya has had a long history with foreign firms. From independence of 1963 through the 1970s and part of the 1980s it was one of the most favoured destinations of FDI in the Eastern 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. In the 1970's Kenya was the most favoured destination for FDI in East Africa. However, over the years she has lost her appeal to foreign investors a situation that has continued to the present. In 2008, Kenya launched vision 2030 with the objective of among other things to achieve global competitiveness for FDI and gain economic prosperity. This initiative has seen a renewed commitment to attract FDI to assist in achieving higher economic growth rates. Kenya has had inconsistent trends of FDI inflows starting with the 1970-1980 period .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 multinational companies (MNCs) choosing Kenya as their regional hub. There was also relative political stability and security during the period. FDI started at a low of around US$ 10 million a year in the early 1970s before peaking at US$ 60 million by 1979-80. The country received relatively large capital inflows

partly driven by rapid expansion in the agricultural sector, expansionary fiscal and monetary policies, sustainable budget deficit and the import substitution industrialisation (ISI) strategy. This involved overvalued exchange rates, import tariffs, quantitative restrictions and import licensing (Ikiara *et al*, 2003). Other factors included large and favourable regional markets from the original East African community (EAC) which attracted FDI into the country (World Bank, 2010). 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 level of FDI inflows. FDI inflows in the period 1981-1999 averaged only US$ 22 million per annum. It is 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 seem 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% for 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 flows in the 1996-2003 period averaged some US$ 29 million annually while flows 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 who's share rose by 34% share, rising to 46% by the year 2003. The same scenario was repeated in the period 2003-2009 where the average FDI flows into Kenya was 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 Kenya 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 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 Opportunity Act (AGOA) after 2001.

Kenya also missed out in the global surge in FDI that was 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 Kenya's poor performance in attracting FDI at a time of global surge of inflows and 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 bad governance, inconsistencies in economic policies, deteriorating public service 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 improvement 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. 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 enhance economic growth. Numerous studies have concluded that exporting is crucial to growth and foreign direct investments can play a role in enhancing the export capability of a country (see Bernard *et al*, 2000; Bernard and Jensen, 2001; Bigsten *et al*, 1999, 2002; Girma *et al*, 2005, and Kneller *et al*, 2004).

The Investment Promotion Act enacted in 2004 is a key policy initiative aimed at promoting foreign direct investment in the country. It provides incentives and promotes foreign direct investments that earn foreign exchange, provide employment and promote backward and forward linkages and transfer technology. The Act, however, took away some of the benefits through imposing compulsory investment certificates and high minimum capital requirements, thus creating a legal barrier to and administrative burden for FDI thereby discouraging both domestic and foreign investment (UNCTAD, 2005). These general restrictions of the Act are contrary to practice in many other countries in Africa and elsewhere in the world that adopt more liberal entry regimes and / or more precisely targeted policies to regulate FDI entry. Tanzania for example does not impose minimum capital requirements for FDI entry in general, but makes special incentives conditional upon holding an investment license and investing a minimum of US$ 300,000 (compared to Kenya's US$ 500,000). Uganda does not require foreign investors to invest minimum amounts but offers the facilitation support of its Investment Authority when investments exceed US$ 100,000. Additionally, the minimum capital requirement does not effectively grant protection to national investors in sensitive areas and maximize the benefits of FDI. The size of investment is by no means an indicator of

"seriousness" and benefits to the economy since at times large foreign investments may crowd out small national investors' as much as more modest foreign investments (UNCTAD, 2005). The UNCTAD(2011) data shows that Tanzania and Uganda have made tremendous improvements in their attractiveness for FDI since 1994. Tanzania's FDI increase has been attributed to the mining sector especially uranium and tanzanite, gas and oil discoveries as well as favourable policies that liberalized both local and foreign investments (Kajara 2010). Uganda's FDI increase has been attributed to a wide range of tax incentives to businesses as well as its own discovery of oil and gas reserves (Ngowi, 2005). This suggests that FDI increases with increases in discovery of natural resources. Furthermore, the UNCTAD (2011) figures suggest that economic growth rate of Tanzania and Uganda has exceeded that of Kenya since 1994 when their FDI begun to increase. This may lend credence to the hypothesis that increases in FDI leads to increases in economic growth, but these are not proportional suggesting that other factors also affect growth.

Table 4.16: Flows into Kenya and Tanzania (in selected years, in US$ million)

	2005-2007 (annual average)	2009	2010	2011	2012
Kenya	267	115	178	335	259
Kenya's FDI as % of Gross Fixed Capital Formation (GFCF)	6.1	-	2.7	4.9	2.9
Tanzania	640	953	1813	1229	1706
Tanzania's FDI as % of GFCF	15.3	-	24.6	15.6	17

Source: UNCTAD (2013).

Table 4.17: FDI stock in Kenya and Tanzania (selected years, in US$ million)

	1995	2009	2010	2011	2012
Kenya	732	2104	2282	2617	2876
Kenya's FDI stock as % of GDP	6.3	-	7.1	7.7	7.0
Tanzania	620	8066	8762	9278	10984
Tanzania's FDI stock as % of GDP	10.2	-	37.1	38.1	38.2

Source: UNCTAD (2013).

UNCTAD (2005) had argued that Kenya's inability to attract FDI is a result of corruption, poor governance, inconsistencies in economic policies and structural reforms, deteriorating public service and poor infrastructure all of which are being addressed. Despite massive efforts by the government to implement reforms such as trade reforms, the country continues to lose its competitiveness for FDI to Uganda and Tanzania. However, Sims (2013) indicates that inflows of FDI to Kenya could match those of Tanzania and Uganda beginning 2014 aided by opportunities created by the discovery of oil deposits in Turkana. The FDI inflows are projected to average US $ 1.3 billion annually for the period 2013-2018, placing it at par with Tanzania and Uganda who had over the years attracted more investors due to their vast natural resources such as gas , oil and other minerals.

The UNCTAD (2011) figures show that Uganda and Tanzania have overtaken Kenya in terms of growth rates due to their rising FDI inflows , but Kenya is still the regional business leader ,is it that FDI is a key factor in driving economic growth or are other factors equally important ?.

Some of these shortcomings have been recognized by the government and it has sought to amend the Investment Promotion Act by making investment certificates optional for all investors .The special incentives remain conditional upon holding a certificate, though the minimum capital requirement to qualify for one would be lowered to US$ 100,000 for foreign investors and US $ 13,000 for national investors.

From the year 2000, the Kenya government has implemented a number of initiatives to improve both economic performance and stimulate foreign direct investments. The government joined the Free Trade Area of the Common Market for Eastern and Southern Africa (COMESA) in 2000; negotiated for the resumption of donor aid by the International Monetary Fund (IMF); adopted the United Nations Millennium Development Goals (MDGs) in 2002 and resolved to reduce poverty levels by half by the year 2015; implemented the Economic Recovery Strategy for wealth and employment creation (ERS) in 2003 to

stimulate private investment to generate wealth and reduce poverty; implemented Kenya's Vision 2030 in 2008 and promulgated a new constitutional dispensation in 2010. The Vision, implemented in successive five-year medium term plans, with the first plan covering the period 2008-2012, is expected to encourage FDI, achieve high average Gross Domestic Product growth rate (of 10% per annum beginning 2012) and boost investments. It is also expected to enhance macroeconomic stability, raise national savings (from 17% in 2006 to 30% by 2012). These measures did see Kenya's growth rise from 0.6% in 2000 to 7% in 2007. The growth rate however fell to 1.6% in 2008 but has been rising since to 4.7% in 2012. The fall in GDP growth was due to global financial crisis; fall in commodity prices and post-election chaos that followed the December 2007 general elections in Kenya.

Despite the recent impressive economic growth, FDI flows to Kenya average below US$ 39 per capita between 2003 and 2006 compared to US$ 418 and US$ 310 for Tanzania and Uganda respectively. By 2009, Kenya's net FDI flows stood at US$ 116 million while Tanzania's and Uganda's US$ 415 and US$ 789 respectively (World Bank, 2012). This is despite the Kenyan governments implementing a series of measures to attract foreign investors that included among others Manufacturing Under Bond (MUB) in 1987, Export Processing Zones (1990) and accession to the African Growth and Opportunity Act (AGOA) in 2001 (World Bank, 2012). The last measure however led to significant FDI inflows from Asia whose investors used Kenya as a platform for quota-hopping to access the otherwise restricted US market, particularly for clothing manufactures (UNCTAD, 2005).

4.1.1.2.   The Study Objectives

It has been argued in numerous studies that FDIs contribute positively to economic growth in the host economies. This is particularly true where FDIs bring in investible financial resources and fill the gap between desired investment and domestically mobilized savings, facilitate entry into export markets, and strengthen the export capabilities of the host country resulting in productivity

gains, technology transfer, introduction of new processes, managerial skill s and knowhow in the domestic markets, employee training, international production networks and access to markets (Caves 1998; Ayanwale, 2007; Borensztein *et al,* 1998. Findlay (1978) also makes a case for the increase in the rate of technical progress in the host country through a "contagion effect" from the more advanced technology as a result of FDIs. FDIs have also been credited with increase in tax revenues and improvement in management and labour skills in host countries (Todaro and Smith, 2003; Hayami, 2001). Employment creations, human capital development, contribution to international investments are some of the positive effects of FDIs (Jenkins and Thomas, 2002; World Bank, 2002).

To the contrary, despite the important role played by FDI in economic growth in host countries, the level of FDI in Kenya has been low and stagnant over the past couple of decades as alluded to above. It is equally clear that FDI flows and GDP growth rates fell in the 1980s and 1990s. After 2000, rising economic growth rates contrasted with low and stagnant FDI flows. Kenya's experience also contrasts with both Uganda and Tanzania where both FDI flows and economic growth have been on a steady rise since the early 1990s.

There are few studies that analyze the empirical relationship between FDI and economic growth in Kenya; these include Kinaro, 2006; Opolot *et al,* 2008, and Mwega and Ngugi, 2007. Though it can be important in informing government investment policy in the host country, the empirical linkage between FDI and economic growth in Kenya is not clear.

On the basis of the foregoing arguments the study will raise two main questions; namely what is the empirical relationship between Foreign Direct Investment and economic growth in Kenya? And what factors determine the FDI flows to Kenya? The objective of the study is to empirically investigate the relationship between foreign direct investment and economic growth in Kenya and to examine and quantify the factors that drive foreign direct investment flows into Kenya. Specifically the study will seek to use Kenyan FDI flows and gross domestic product data to establish the empirical relationship between foreign direct

investment and economic growth in Kenya with a view to quantify the relationship. The study also seeks to determine and empirically quantify the factors that drive FDI flows into Kenya and to suggest policy options that can be implemented to increase both FDI inflows into Kenya and hence increase economic growth in the economy based on the results of the study.

The rest of the paper is organized as follows. Following this introduction, the next section briefly reviews the literature on the FDI and economic growth and their relationship as well as providing the theoretical foundation of the study; this is followed by a brief presentation of the methodology and a theoretical framework to be used in the study and includes a model to be estimated. The section also briefly discusses the types and sources of the data used in the study. The last section discusses the results and policy implications based on the results of the study.

4.2. Literature Review

4.2.1. Introduction

In this section we briefly review some of the theoretical and empirical literature on foreign direct investments and economic growth. The section is divided into three parts comprising theoretical literature review, empirical review and an overview of the literature.

4.2.2. Theoretical Foundation

It has been argued that foreign direct investment can either positively or negatively affect economic growth in the host economies. There are many channels through which FDI can impact on growth. Blomstrom et al (1994) argue that FDI exerts a positive effect on growth but there is a threshold level of income above which FDI has a positive effect on economic growth and below which it does not or is insignificant. Borensztein et al (1998) is of the opinion that the interaction of FDI and the quality of human capital has important effect on economic growth and suggests that the differences in the technological

absorptive ability may explain the variation in growth effects of FDI across countries .They point out that countries may need a minimum threshold of human capital to experience positive effects of FDI on economic growth. It is similarly suggested by Oloffsdotter (1998) that the beneficial effects of FDI are stronger in the countries which have a higher level of institutional capability.

In another study Alfaro et al (2003) find little support that FDI has an exogenous positive effect on economic growth, however, their findings suggest that local conditions such as the level of education and the development of local financial markets play an important role in allowing the positive effects of FDI to materialize in the economy.

Many studies exist concerning FDI and its determinants, where the main factors include the rate of investment return, market size, macroeconomic variables (especially their stability), quality of labour, infrastructure, property rights and the effects of globalisation which has led to FDIs in LDCs to shift from market seeking and resource seeking to the more efficiency seeking FDIs.

The literature indicates that there is no conclusive argument on factors determining FDI and its subsequent effect on economic growth. Causality between FDI and growth is still unclear. The direction of FDI might be associated with domestic policy variables. The direction of the relevant causalities between FDI and growth may well depend on the determinants of FDI. If the determinants have strong links with growth in the host country, growth may be found to cause FDI, and output may grow faster when FDI takes place in other circumstances like the case of oil discovery.

The understanding of the impact of specific categories of foreign capital inflows has important policy implications. Most studies on the growth of specific types of foreign capital flows focus on FDI. However, the empirical evidence on FDI and its impact on host countries growth are ambiguous at both the micro and macro level.

The positive effects on the growth of the host economy can come from investible financial resources filling the gap between investment and domestically mobilized savings, facilitation of entry into export markets and strengthening export capabilities of the recipient country. Caves (1998) has postulated that other positive effects of FDI include productivity gains, technology transfer, new processes, managerial skills, employee training, international production networks and access to new markets. Borensztein *et al* (1998) see FDI as an important channel for transfer of technology and contributing to growth in larger measure than domestic investment. Findlay (1978) postulates that FDI increases the rate of technical progress in the host country through what he calls a "contagion effect" from the more advanced technology, superior management practices used by the foreign firms. Todaro and Smith (2003) and Hayami (2001) noted that FDI may also increase tax revenue, improve management, technology as well as labour skills in host countries. Many other studies have noted the benefits of FDI to include new technology, employment creation, human capital development, international trade integration, enhancing domestic investment, and increased revenue (Jenkins and Thomas, 2002; World Bank, 2000). FDI is seen as being a positive contributor to the economic growth of the host country.

However, it has also been argued that foreign direct investments can also have adverse effects on the economy of the host country. Reis (2001) has advanced the argument that opening up a country to FDI in the research and development sector may replace the domestic firms and decrease welfare due to the transfer of capital returns to foreign firms.

Firebaugh (1992) points out that the foreign firms may fail to encourage local entrepreneurship, reinvest profits, develop linkages with domestic firms or fail to use appropriate technology. FDI can be detrimental if it "crowds out" domestic businesses and engenders inappropriate consumption patterns or reduce domestic savings and investment rates by stifling competition through exclusive production agreements with the host country. FDI may also lead to less than

optimal corporate taxes where they are provided with liberal tax concessions and excess investment allowances and other incentives. In a distorted market, FDI can lead to negative value-added at world prices coupled with repatriation of profits and dividends (Mwega and Ngugi, 2007). The study is based on the theory of profit maximisation, such that the country's GDP can be increased by the input of the FDI inflows which enhances its productivity as it helps local firms to be more productive through the infusion of capital and more modern and efficient technologies that it brings as well as fostering competition both locally and in the country's foreign markets.

It is generally believed however, that FDI provides net benefits to the host country. This explains why the importance of FDI in economic performance has been extensively discussed in the economic literature.

4.2.3. Empirical Studies

Several studies have been conducted on the empirical relationship between FDI's and economic growth. Some of these studies have shown that FDIs positively influence economic growth in the host countries. Dees (1998) in a study on the determinants and effects of foreign direct investments in China found that FDI has been important in explaining China's economic growth. Similarly, de Mello (1997) also presents a positive correlation between FDIs and economic growth of selected Latin American countries. Barrel and Pain (1999) explored the benefits of FDI of U.S multinational in four European Union countries and find that FDI may affect the host country's performance positively in the case where there are transfers of technology and knowledge through the FDI to the host economy.

Firm-level studies of specific countries provide contradictory evidence on the role played by FDI in economic growth. For example Wilmore (1986) examining a sample of 282 pairs of firms from 80 industries in Brazil found that FDI had a beneficial impact on growth since foreign firms are more efficient than domestic ones. Moreover, Blomstrom (1986) found that FDI enhances productivity growth of Mexican firms. FDI spillovers that occur when the entry or presence of a

foreign investment firm(s) contribute to the productivity or efficiency benefits of indigenous firms are critical in defining the impact of FDI on the growth of host nations.

The literature identifies competition, linkages, labour mobility, skills and imitation as the main channels of technological spillovers from FDI to indigenous firms (Blomstrom and Kokko, 1998). We however, note that FDI spillover may either be positive or negative on their impact on economic growth in the host countries. Some empirical studies show positive effects of FDI spillovers on economic growth in the host countries.

Some empirical studies show positive effects of FDI spillovers on economic growth (Caves, 1974) on Australia and Kokko (1994) for Mexico. However, Haddad and Harrison (1993) find no evidence of positive spillovers from FDI in Morocco. The study by Aitken and Harrison (1999) for Venezuelan firms in the period 1979-1989 and Djankov and Hoekman (2000) for the Czech Republic firms report negative spillovers. Hanson (2001) concludes that the evidence that FDI generates positive spillovers for host countries is weak. Microeconomic studies report positive effects of FDI and productivity spillovers, these include studies by Lipsey and Sjöholm, 2004; Black and Gertler, 2008. Most macroeconomic studies generally suggest that FDI exerts a positive impact on economic growth in particular contexts. Balasubramannyam *et al* (1996) and Zhang (2001) find that effects on growth of FDI are more significant in the presence of trade openness and where host country adopted liberalisation. Borensztein *et al* (1998) argue that FDI is an important channel for the transfer of technology and contributes to economic growth when the country has a highly educated workforce. Blomstrom *et al* (1994) found that among developing countries, the positive impact of FDI on growth is larger in those countries that exhibit higher levels of per capita income. FDI is also beneficial for economic growth when the country has sufficiently developed and sophisticated financial markets (Alfaro *et al, 2004*). The other factors that enable FDI to positively impact on growth include political and economic stability as well as the quality of institutions and infrastructure

which complements FDI (see Oloffsdotter, 1998; Hall and Jones, 1999; Rodrik *et al*, 2002; Aschauer, 1989 and Tondl and Prüfer, 2007). The literature therefore suggests that openness to trade, human capital, financial market development, public infrastructure and quality of institutions affects a host country's ability to absorb FDI spillover.

The literature on FDI shows that its impact on economic growth can either be direct or indirect. The indirect impact or spillovers are dependent on the host country's conditions. Specifically this depends as per capita income, human capital stock, financial sectors level of sophistication, the level of development and quality of public infrastructure, the quality of institutions, trade openness and macroeconomic stability. The empirical evidence however shows that the relationship between FDI and growth is uncertain and varies across host countries. This paper proposes to use Kenyan data to find out whether FDI enhances economic growth in Kenya.

Using panel data for 25 central and Eastern European and former Soviet transition economies, Campos and Kinoshita (2003) examined the effects of FDI on growth for the period 1990-1998. Their main results indicated that FDI has a significant positive effect on economic growth of each country. Focusing on the factors that explain growth in developing countries, Blomström *et al* (1994) found that foreign direct investments exerts a positive effect on economic growth but that there seems to be a threshold level of income above which FDI has positive effect on economic growth and below which it does not. The explanation is that only those countries that have reached a certain income level can absorb new technologies and benefit from technology diffusion, and thus reap the extra advantages that FDI offer. They concur with other studies that suggest human capital as one of the reasons for the differential response to FDI at different levels of income (Borensztein *et al,* 1998; Bengos and Sanchez-Robles, 2003).

However, some studies have found that FDI may not influence long-run economic growth. In a study on the interaction between foreign direct investment, economic freedom and growth, Bengos and Sanchez-Robles (2003) estimated the

relationship between FDI and economic growth using panel data for eighteen Latin American countries over the period 1970-1999. They show that FDI had positive and significant impact on economic growth. However, they also found that the host country requires adequate human capital, political and economic stability and liberalized market environment so as to gain from long-term FDI inflows. It has also been shown by Ang (2008) that better developed financial systems allow an economy to exploit the benefits of foreign direct investment more efficiently. The author used Thailand as a case study to examine the role of FDI and financial development in the process of economic development. The estimation uses an unrestricted error-correction model to avoid omitted lagged variable bias, and an instrumental variable to correct for endogeneity bias. Using annual firm series data from 1970-2004 the results show that financial development stimulates economic development whereas foreign direct investment impacts negatively on output expansion in the long-run. However, an increased level of financial development enables Thailand to gain more from FDI, suggesting that the impact of FDI on output growth can be enhanced through financial development.

Some studies indicate that the relationship between the FDI and economic growth is weak and insignificant. Ayanwale (2007) investigating the empirical relationship between non-extractive FDI and economic growth in Nigeria using annual time series and ordinary least squares technique found the relationship between FDI and economic growth to be positive but not significant.

4.2.4. Overview of the Literature

It is clear from this brief review that the effects of FDI on growth are dependent on the characteristics of the host country and the sectors where the FDI is directed. Large market size and high incomes may attract market seeking FDI as opposed to small and low income economies. Market-seeking FDI is therefore induced by market access to host countries for efficient utilization of resources and exploitation of economies of scale. FDI complements growth when directed towards highly productive sectors of the host economy. Investment in

development of good quality infrastructure, low cost and highly skilled human capital and innovations and technological progress increase productivity and promote growth in the long-run. The empirical evidence shows that the relationship between FDI and growth and the expected significance of the determinants of FDI varies across host countries.

The empirical evidence shows that the relationship between FDI and growth and the expected significance of the determinants of FDI varies across host countries. Some studies show positive effect of FDI on economic growth while others show negative impact; whereas some studies exhibit insignificant relationship between the two variables. The differences in empirical results may be attributable to differing economic institutional and technological conditions in the recipient countries. The few country specific studies also indicate that there may be endogenous relationship between FDI and growth which may have to be taken into account if the results are to be robust.

The next section presents the methodology used in the study.

4.3. Theory and Empirical Model

In this section we present the methodology used in the study. The methods are outlined before the model is specified. Section 3.2 briefly presents the types, sources and measurement of the data used.

The relationship between FDI and economic growth is situated in growth theory that pronounces the role of improved technology, efficiency and productivity in promoting growth (Lim, 2001). However, the potential contribution of FDI to growth is dependent strictly on the on the circumstances in the recipient or host countries. Certain host country conditions are necessary to facilitate the spill-over effects.

In this study, we assume in line with standard economic theory that foreign capital inflows into a recipient country will increase its stock of capital and level of technology and lead to better economic performance. Foreign direct

investment will affect economic growth positively through improved technology, efficiency and increased productivity (Lim, 2001). However, as noted in the review of literature, the potential contribution of FDI to growth is strictly dependent on the circumstances in the recipient or host country. Theoretically a country's GDP is influenced by a variety of factors. RGDP is measured as nominal GDP deflated by the GDP deflator, (base 2000 s=100).

We hypothesise FDI to positively influence growth. FDI promotes economic growth in host countries by providing external capital (O'hearn, 1990). Apart from increasing tax revenues, improving managerial and labour skills it also creates employment in the host country. The gross fixed domestic investment (GFDI) is proxied in this study by the share of the gross domestic capital formation to GDP less net FDI flows. Increased investments rates promote productivity in a country as argued by Grossman and Helpman (1991). We expect a positive relationship between this variable and GDP. The level of human capital measured here by the secondary school enrolment rate should have a positive impact on GDP. It can be argued that widespread availability of cheap and highly skilled labour force tends to attract private investment and enhances productivity in a country (Akinlo 2004, Barro and Lee, 1994). The rate of inflation measured here by the annual percentage change in consumer price index is a reflection of macroeconomic stability. A low and stable inflation rate implies a more reliable economic environment enabling investors to benefit from existing opportunities (see Larrain and Vergara, 1993; Serven and Solimano, 1993). A negative relationship exists between inflation and GDP.

The size of Government (GOVSIZE) is measured in this study by the share of total government consumption to GDP. Anyanwale (2007) points out that higher level of general final government consumption provide social capital that encourages production and growth. Trade openness (OPEN) on the other hand promotes economic growth through increasing competitiveness and providing access to markets for finished products, (Balassa, 1978). It also enables the importation of raw materials and capital goods and facilitates access to new technologies and

skills. Large export markets encourage inward market-seeking FDI and foreign capital inflows (Kinaro, 2006; Ajayi 2007).

There are evidently other influences on GDP with varying degrees of importance are captured by the error term (e) in our specification.

4.3.1. As explained in the The Model

section above, equation 1 below shows the hypothesized relationship between economic growth and its determinants.

We hypothesize economic growth to be influenced by several factors as shown in the model below

$$RGDP = f(FDI, GFDI, UMCAP, INFL, GOVSIZE, OPEN, ROI, INFRAC, TDS, CPI)........(1)$$

Where

RGDP = Real Gross Domestic Product

FDI = Foreign Direct Investment

GFDI = Gross Fixed Domestic Investment

HUMCAP = Level of Human Capital

INFL = Rate of Inflation

GOVSIZE = Government consumption

The equation which relates the real gross domestic product to various factors that influence it can be elaborated as

$$RGDP = g_0 + g_1 FDI + g_2 HUMCAP + g_3 INFL + g_4 GOVSIZE + g_5 OPEN + g_6 + \varepsilon).......(2)$$

Where g_1,....., g_6 are the coefficients to be estimated and g_0 is the constant. ε is the error term.

Equation (2) above shows the growth model to be estimated.

When estimating the growth equation it is possible that some of the variables could be correlated to the error term resulting in a problem of endogeneity and could give rise to biased estimated coefficients. If this were to happen appropriate instruments will be searched and used in a 2 stage least squares (2SLS) estimation.

Since we also wish to quantify the factors that drive direct foreign investment (DFI) inflow into the country we shall estimate an FDI equation. We hypothesize that direct foreign investment is influenced by a variety of factors as shown below:

$$FDI = \Re_0 + \Re_1 RGDP + \Re_2 INFRAC + \Re_3 OPEN + \Re_4 GR +$$
$$\Re_5 RLIR + \Re_6 TDS + \Re_7 ROI + \mu \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(3)$$

Where

FDI = Foreign Direct Investment measured share of FDI to GDP

RGDP = Real Gross Domestic Product (nominal GDP deflated by the GDP deflator

HUMCAP = Level of Human Capital (proxied by the secondary school enrolment rate)

GR = Market size (measured by annual % change in real GDP)

RLIR = Real Interest rate (measured by the difference between the nominal lending interest rate and the rate of inflation

GFDI = Gross Fixed Domestic Investment (proxied by the share of the gross domestic capital formation to GDP less net FDI inflows)

OPEN = Openness of the economy (measured by the ratio of trade exports + imports to GDP)

INFRAC = Infrastructure (proxied by the electric power transmission and distribution losses as a % of the total output)

INFL = Inflation rate measured by the annual % change in consumer price index

TDS = Total debt service to GDP ratio measured by the share of total external debt service to GDP

CPI = Corruption Perception Index

ROI = Return on Investment proxied by long-term US interest rates

GOVSIZE = Government consumption measured by the share of the total government consumption to GDP

μ = The Stochastic error term

The coefficients $\mathfrak{R}_0$............$\mathfrak{R}_7$ are to be estimated.

In the FDI model equation (3) above, FDI is measured as the ratio of FDI to GDP and is the dependent variable. It is hypothesised that a high real GDP reflects large market size that attracts further FDI especially the market seeking ones, resulting in more demand for products or services to be provided by FDI (Chunlai, 1997; Mwega and Ngugi, 2007). The Gross Fixed Domestic investment increases the rate and efficiency of domestic capital investment, raising productivity in a country and thereby encourages FDIs. We expect a positive impact on FDI. The measure of openness is as defined above. This may encourage exports and hence lead to market seeking FDIs

Infrastructure is critical for both economic growth and competitiveness. In this study it is proxied by

Electric power transmission and distribution losses as a percentage of total output. We expect this to have a negative impact on FDI inflows as it relates to high cost of production (see Anyanwale, 2007).

The real exchange rate has an important impact on FDI inflows. A depreciation of the exchange rate

Encourages higher inflows as it makes local assets and production costs cheaper. An appreciation of the exchange rate has the opposite effect.

The choice of variables included in the model specifications has been guided by the theories of economic growth and the determinants of FDI inflows discussed in the literature review above.

The following section elaborates the sources and types of data used in the study.

4.3.2. Data Sources, Types and Measurement

The study covers the period 1970-2010; and therefore includes the period which Kenya was the preferred FDI destination in East Africa as well as the period in which she was overtaken by both Tanzania and Uganda as the main FDI destinations in the region.

The data is annual time series data obtained from secondary sources. The sources include the Central Bank's annual economic reviews, Republic of Kenya Statistical Abstracts and economic surveys produced by the Kenya National Bureau of Statistics (KNBS). Other sources of data included the World Bank's World Development Indicators and Global Development Finance reports. The UNCTADs World Investment reports and the IMF's International Financial Statistics have also been used. Due to difficulties in obtaining certain qualitative data on such variables like corruption it was left out of the analysis even though we are acutely aware that corruption levels in a country can have a major negative impact on the inward flow of FDIs.

4.3.2.1.   Time Series Properties and Estimation Tests

Given the time series nature of our data, it was imperative to carry out estimation tests to be sure that our data is not non-stationary so that we avoid the problem of spurious regression results. We therefore conducted stationarity tests for the series using the Augmented Dickens Fuller (ADF) test. The ADF assumes that the error terms are independently and identically distributed. A time series data is said to be stationary if its mean, variances and autocovariance remain the same no matter at what point we measure them.

Unit root test for stationarity results

We used the Augmented Dickens Fuller test to test for stationarity in our data. The test indicates whether or not the variables are stationary. The null hypothesis is that of non-stationarity while the alternative hypothesis is that of stationarity. The test statistic is then compared with the t-critical. If the t-statistic is less than t-critical we reject the null hypothesis of non-stationarity and therefore the series is stationary. On the other hand, if the t-statistic is more than the critical we accept the null hypothesis and non-stationarity and the series is therefore non-stationary and prone to spurious regression. The table below shows that our data was stationary and we do not face the possibility of spurious regression results.

Table 4.18: Unit Root Test using ADF

VARIABLE	ADF STATISTIC	1% CRITICAL VALUE	5% CRITICAL VALUE	10% CRITICAL VALUE	NATURE
RGDP	-6.900	-3.648	-2.958	-2.612	STATIONARY
GR	-5.015	-3.648	-2.958	-2.612	STATIONARY
FDI	-6.941	-3.648	-2.958	-2.612	STATIONARY
HUMCAP	-6.426	-3.648	-2.958	-2.612	STATIONARY
OPEN	-6.303	-3.648	-2.958	-2.612	STATIONARY
INFRAC	-5.139	-3.648	-2.958	-2.612	STATIONARY
GOVSIZE	-5.190	-3.648	-2.958	-2.612	STATIONARY
TDS	-6.008	-3.648	-2.958	-2.612	STATIONARY
INFL	-6.352	-3.648	-2.958	-2.612	STATIONARY
RLIR	-5.772	-3.648	-2.958	-2.612	STATIONARY
ROI	-6.761	-3.648	-2.958	-2.612	STATIONARY

Results in table 4.18 above show that the ADF test statistics are less than the t-critical at the 1%, 5% and 10% and we therefore reject the null hypothesis of non-stationarity and accept that the series are stationarity and our OLS regression could be conducted since the results would not be spurious (The OLS results are shown in tables 4.17 and 4.18).

The study hopes to determine the important variables that may be important in encouraging the inflow of direct foreign investment to Kenya and recommend policies that can enhance the inflow of FDI into Kenya. The study also hopes to determine the empirical relationship between economic growth and foreign direct investment in Kenya with the view to both boost inflow of direct foreign investment and economic growth.

Having elaborated the hypothesised relationships between our dependent variables and the independent variables in the two models we estimated the relationships using time series data and the results are discussed in the following section.

4.4. Results and Discussion

4.4.1. Introduction

We set out to empirically investigate the relationship between foreign direct investment and economic growth in Kenya by examining the factors that drive foreign investment flows into Kenya. The objective was to establish the empirical relationship between FDI and economic growth in Kenya.

4.4.2. Regression Results

4.4.2.1. The growth equation

From our results in table 4.16 we see that the growth in GDP is positively influenced by human capital and the variable is significant at the 1% level (t-value=4.96) and a P- value=0.000. The results also show that the government expenditure (GOVSIZE) is a significant determinant of the real GDP.T he

variable is significant at the 1% level with a t-value of 3.17 and a p-value of 0.003.

Table 4.19: Determinants of RGDP

Variables	Coefficient	Standard Error	t-values	P-values
fdi	1949.496	2514.297	0.78	0.443
humcap	822.911	166.0322	4.96	0.000
infla	9.835928	32.06965	0.31	0.761
govsize	3523.373	1111.173	3.17	0.003
open	585.8971	215.6161	2.72	0.001
_cons	-45026.6	23981.22	-1.88	0.069

No. of obs = 41; F(6, 34)= 21.28; Prob>F = 0.0000; R-Squared = 0.7897; Adj R-Squared = 0.7526; Root MSE = 8237.2

It was argued that the government size which is measured by the share of total government consumption in GDP should influence economic growth in a positive manner. The higher the level of the general final government consumption the more the social capital and this encourages production and the growth of GDP. The results indicate a highly significant coefficient (t-value=3.17) at the one percent level of significance. The results therefore suggest that government consumption is a major contributor to GDP growth and should be encouraged. It appears that government expenditure on social services and other amenities is an important boost to growth.

The openness of the economy to the rest of the world is similarly shown to be a major driver of the GDP growth rate. The variable was measured as the ratio of trade defined as imports plus exports to the GDP. The idea here is that trade openness promotes economic growth through increasing competitiveness and providing access to markets both for finished products and exports as pointed out by Balassa (1978). By enabling importation of raw materials and capital goods and facilitating access to new technologies and managerial skills it

positively impacts on the growth of GDP. The coefficient is large and positive and is reported to be significant at the 1% level (t-value=2.72) with a p-value of 0.010.

The variables in the growth equation explain about 80% of the variations in the GDP growth rate and the overall model seems to be well specified with an F-statistic of 21.2. The p-value for the model as a whole indicates it is fairly well specified.

4.4.2.2. The FDI equation

The results in our table 4.17, shows the determinants of FDI inflows to Kenya. The real gross domestic product measured as defined above is shown to be a major influence on the FDI inward flow.

Table 4.20: The determinants of FDI

Variables	Coefficient	Standard Error	t-values	P-values
rgdp	2.69E-05	1.09E-05	2.47	0.019
infrac	0.066262	0.03405	1.95	0.06
open	0.017142	0.013785	1.24	0.223
gr	-0.00854	0.022764	-0.37	0.71
rlir	-0.00668	0.010635	-0.63	0.534
tds	0.072952	0.043933	1.66	0.107
roi	-0.07517	0.05979	-1.26	0.218
_cons	-0.73934	1.102412	-0.67	0.507

No. of obs = 41; F(8, 32)= 1.86; Prob>F = 0.1011; R-Squared = 0.3179; Adj R-Squared = 0.1474; Root MSE = .52994

The theoretical basis for this is that a high real GDP reflects a large market size that attracts FDI, especially the market seeking type. The high GDP leads to higher demand for the products and services provided by the foreign firms. A high real GDP therefore has a positive influence on the FDI. The results in table 4.17 show that the variable is highly significant at the 1% level and has a *t*-value of 2.47. The coefficient is positive as was hypothesized. The results further show that the infrastructure is also an important influence on the FDI inflow. The

variable has a positive coefficient and is significant at the 10% level with a *t*-value of 1.95. We had proxied infrastructure by electric power transmission and distribution losses as a percentage of total output. The expectation was that it would have a negative impact on FDI inflows due to the measurement method employed as it relates to high cost of production. However, the results do not support this hypothesized relationship. It is possible and even likely that good infrastructure which improves a country's competitiveness may in fact attract FDI flows due to improved cost conditions in a country.

The variable on total external debt service as a ratio of GDP (tds) captures the liquidity and solvency constraints imposed by the debt burden and the higher the debt services ratio the more it deters FDI inflows. The results indicate that the coefficient is positive though not statistically significant. The a priori expectation was that it would be negative due to the negative impact of the debt burden which discourages FDI flows.

These results imply that Kenya can attract more FDI which are acknowledged to have potential benefits that can accrue to the country. FDI is important for economic growth as it provides the much needed capital for investment, increases competition within the country and aids local firms to become more productive by adopting more efficient technology or by investing in human or physical capital. FDI also contributes to growth in a substantive manner because it is more stable than other forms of capital flows.

4.5. Conclusion and Policy Implications

The driving objective of this study was to investigate the empirical relationship between Foreign Direct Investment and economic growth in Kenya. The study also set out to empirically investigate the factors that drive FDI flows into Kenya, having established that Kenya's FDI inflow record over the recent years has not been impressive despite her being among the most favoured FDI destinations in the 1970s in Eastern Africa. The realisation that Kenya is now among the countries with very low levels of FDI motivated the study. By establishing

empirically which factors drive both growth and FDI inflows to Kenya, it is possible to design policies that can attract the flows into Kenya.

The study has shown that human capital, government expenditure and openness of the economy are vital for the growth of the economy and therefore policies that can enhance these factors would be needed. Furthermore, the drivers of Foreign Direct Investment have been shown to be the real GDP growth, low levels of indebtedness and improved infrastructural facilities. It is clear that the role of government would be crucial in encouraging FDI inflow to Kenya. It can also be argued that most FDI to Kenya is the market-seeking type and this requires a rapidly growing real GDP. The formation of regional blocks, and political stability would also be crucial. It can be concluded that the main FDI determinants in Kenya are market size (rgdp), political stability (d2007) and openness of the economy as well as infrastructure. The major impediments to FDI inflow would be political instability, institutional factors as well as crime and insecurity. There is little doubt that the cost of doing business, bureaucratic red-tape, high cost of electricity and other utilities and poor investment code as well as endemic corruption are some of the factors that help explain the low FDI inflows into Kenya in the recent decades.

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CHAPTER 5

Implications of WTO NAMA Negotiations On Exports of EAC Manufactured Products

Lucia Mary Mbithi

5.1. Introduction

5.1.1.   WTO NAMA negotiations

The WTO Non -Agricultural Market Access (NAMA) negotiations are a part of the Doha Development round of negotiation initiated in 2001.The Doha Ministerial conference held in 2001 agreed to further liberalize trade on non-agricultural goods. This liberalization was a continuation of the earlier work undertaken under the Uruguay Round of negotiations, where WTO member countries had made commitments to reduce tariffs and to bind their tariff rates. Unlike in the case of the agricultural sector, under the Uruguay Round of negotiations, there is no legally binding agreement on industrial goods tariff reduction targets, but countries listed their commitments to reduce and bind tariffs on goods schedule. Tariffs in the manufactured sector had however reduced substantially through earlier WTO rounds of negotiations.

The aim of NAMA negotiations under the Doha round is to reduce or as appropriate eliminate tariffs, including the reduction or elimination of tariff peaks, high tariffs, and tariff escalation, as well as non-tariff barriers, in particular on products of export interest to developing countries (WTO, 2001). Products coverage in these negotiations is expected be comprehensive and without a priori exclusions. The negotiations are also expected to take   into account the special needs and interests of developing and least-developed country participants, including through less than full reciprocity in reduction commitments.

Since the start of NAMA negotiations within the framework of the Doha Work Programme in 2001, efforts at the WTO have been directed towards agreeing on the negotiation modalities. Two approaches have been discussed: tariff reduction through a tariff reduction formula, and through 'critical mass approach', where countries would voluntarily agree to reduce tariffs in a sector of their interest.

At the Hong Kong Ministerial Conference (WTO, 2005), a formula (Swiss formula) was adopted as the approach for tariff cuts in the NAMA negotiations. The Swiss formula (WTO, 2008) is presented in equation 1.

$$t_1 = \frac{\{a \text{ or } (x \text{ or } y \text{ or } z)\} \times t_0}{\{a \text{ or } (x \text{ or } y \text{ or } z)\} + t_0} \quad \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots 1$$

where,

$t_1 = $ Final bound rate of duty

$t_0 = $ Base rate of duty

$a = $ 8 = Coefficient for developed Members

$x = 20$, $y = 22$, $z = 25$ (to be chosen depending on paragraph 7 of the WTO, 2008) = Coefficients for developing Members.

According to WTO (2008), tariff reduction will commences on the 1 January of the year following the entry into force of the DDA results and implementation will be made every successive year. Tariff reduction is to be based on the bound duty rate. The tariff reductions for developed member countries are to be implemented within a 5 years period in 6 equal rates while for the developing member countries, it will be done within a 10 year period in some 11 equal rate reductions.

As a part of the WTO Special and Differential Treatment (S&DT), Least Developing Countries (LDC), are exempted from tariffs cuts using the proposed tariff cut formula. Developing countries with a tariff binding coverage of less than 35% of their non- agricultural products tariff lines are exempt from formula reductions. These countries include: Cameroon; Congo; Côte d'Ivoire; Cuba; Ghana; Kenya; Macao, China; Mauritius; Nigeria; Sri Lanka; Suriname; and Zimbabwe.

Developing countries subject to the formula have further been granted flexibilities in the tariff cut formula coefficient (x, y and z) each with a respective condition (WTO, 2008)

The above proposed approach to tariff reduction is expected to lead to tariff harmonization i.e. narrowing the gap between the high and the low tariffs and is proposed for use by developed countries and some developing countries. LDCs are exempted from use of the formula but are encouraged to increase their tariff binding coverage.

Four of the EAC Partner States countries (Burundi, Rwanda, Tanzania and Uganda) are classified as LDCs while Kenya, although classified as a developing country has a tariff binding coverage of less than 35% of her non- agricultural products. With the current proposals of tariffs negotiation at the WTO, the five EAC Partner State countries do not have to reduce their tariffs on non agricultural products. Kenya however is expected to bind (set maximum tariffs above which it is difficult to raise) 75% of her tariff lines at an average rate not exceeding 30%, within a period of 11 years after DDA implementation.

5.1.1.1.   EAC integration and industrial sector

The current efforts in regional integration by East African Community Partner State countries started with the launch of the East African Tripartite Commission in1993. The East African Community (EAC) was established in 1999, then made up of three countries: Kenya, Tanzania and Uganda, with Burundi and Rwanda joining the Community in 2007. The objective of the Community is to develop

policies and programmes aimed at widening and deepening co-operation among the Partner States in political, economic, social and cultural fields, research and technology, defence, security and legal and judicial affairs, for their mutual benefit (EAC Secretariat, 1999). Progress in integration has seen the EAC become a Customs Union in 2005 with a Common External Tariff (CET), and a Common Market in 2010. The region aims to have a common currency, and to achieve a political federation in 2015. The onset of the Customs Union has seen some increase in intra EAC trade. The intra EAC industrial products' exports and imports account for about 20 percent and 6.5 percent of the total EAC industrial goods exports and imports respectively .

5.1.1.2.   EAC industrialization policy

The importance of the industrial sector in the EAC development has been clearly recognized in key EAC policy documents, including the treaty establishing the EAC (EAC Secretariat, 1999), the   EAC Common Market Protocol (EAC Secretariat, 2004), and in the EAC industrialization policy and strategy (EAC Secretariat, 2012 a&b), among other key regional policies.

The theme for the current regional industrialization strategy is 'structural transformation of the manufacturing sector through high value addition and product diversification based on comparative and competitive advantages of the region'. Objectives of the policy include: diversifying the manufacturing base, strengthening national and regional institutional capabilities for industrial policy design, strengthening of research and design, technology and innovation capabilities, expanding trade in manufactured products and transforming micro, small and medium enterprises (MISMEs) into viable and sustainable business entities.

The EAC industrial strategy has prioritized six sectors for the period 2012- 2032 including: iron-ore and other mineral processing; fertilizers and agrochemicals; pharmaceuticals; petro-chemicals and gas processing; agro-processing; and energy and Bio-fuels.

5.1.1.3. EAC Industrial sector

The contribution of the manufacturing sector to the EAC Partner States economic production is relatively less with the sectors contribution to Gross Domestic Product (GDP) being over 10% of the GDP in only Burundi and Kenya. Contribution to merchandise exports is significant being over 20% for Kenya, Tanzania and Uganda. The sector forms the bulk of merchandise imports. The sector also contributes to about 10 of wage employment in the region.

Table 5.21 summarizes the importance of the industrial sector in the EAC Partner State economies.

Table 5.21: Contribution of the manufacturing sector to the EAC economies (2010)

EAC Partner State	GDP (%)	Exports (% of merchandise exports)	Imports (% of merchandise exports)
Burundi	10.5	5.9	81.6
Kenya	11.4	34.7	62.7
Rwanda	6.6	7.6	75.6
Tanzania	9.6	24.1	60.4
Uganda	8.3	22.8	65.1

Source: World Bank (2012): World Bank Development Indicators

Tariffs applicable to EAC Partner States extra imports of various manufactures are in line with those of the East African Community (EAC) Common External Tariffs (CET). These are categorized in three broad bands of raw materials, intermediate and finished goods with rates of tariffs being 0 percent, 10 percent and 25 percent respectively. Products considered as sensitive in the EAC region face applied tariffs much above those of the finished goods. Under the EAC Tax remission scheme, some products upon request by specific EAC countries, considered as inputs in manufacturing sector are imported on zero duty rate.

Among the key challenges to industrialization in the EAC (EAC Secretariat, 2012 a&b) include: policy and regulatory frameworks, inadequate institutional capabilities, limitations in access to financial resources, shortages of essential skills, inadequate infrastructure, and limitations in research and development.

5.1.1.4.   EAC Exports of manufacturing goods

EAC countries export about 7,633 tariff lines of industrial goods (Hs classification, six digit level). The major top 20 exports products are shown in Table 5.22. Over 17 percent of these tariff lines have a revealed comparative advantage of greater than 1 in all the EAC countries, indicating that EAC countries have a potential in development and export of these products. Industrial goods exports are concentrated in products of the mining (chapter 25-27, mineral fuels). It is noted that such products are exported with limited processing. Fisheries and related products, textiles and apparels are also important industrial exports from the EAC. Exports of the mining and related products account for about 20 percent of the total industrial goods exported from the region. Export of industrial goods.

Table 5.22: Top 18 EAC exports of manufactured goods (2010)

HS code	Product Name	Imports Value (US$ '000)	Proportion (%)
261690	Other precious metal ores and concentrates	287791	9.7
271019	Petroleum Oils And Oils From Bituminous Minerals (other Than Crude)	210697.3	7.1
30419	Other fish (Fresh or chilled)	154417	5.2
30429	Other fish (-Frozen fillets)	89541.23	3.0
252329	Portland cement other than the white Portland cement	89293.34	3.0
620462	Women's trousers of cotton	66227.15	2.2
261590	Other	64750.71	2.2
740200	Unrefined copper; copper anodes for electrolytic	60682.56	2.0
850213	Of an output exceeding 375 kVA	53793.76	1.8
271011	(2002-) Light oils and preparations	52984.33	1.8
300490	Other	35187.76	1.2
630491	Knitted or crocheted	35131.91	1.2
740400	Copper waste and scrap	33286.54	1.1
250100	Salt (including table salt and denatured salt) and	30449.93	1.0

410621	(2002-) In the wet state (including wet blue)	27595.65	0.9
870210	With compression-ignition internal combustion	26566.54	0.9
610462	Of cotton	26499.93	0.9
701090	(-1995, 2002-) Other	26354.98	0.9
Total top 20			46.0
All manufactured		*2981364*	*100.0*

Source: TRAINS

Table 5.23 shows the export destination markets for the EAC countries' manufactured products exports. The top 10 export destination markets plus the EAC market itself account for a market share of over 94%, showing clearly a high concentration of EAC export markets, first to EAC itself and to a few other developed and developing countries. Of the top 10 export destination markets, the highest tariffs (of about 17%) are charged by Ethiopia, while the other countries charge tariffs of less than 10%.

Table 5.23: Export destination markets for EAC manufactured goods (2010)

Export destination Market	Average applied tariff (%)	Imports Value in 1000 USD	Share (%)
European Union	0	505216.9	16.9
China	6.4	422444.9	14.2
United States	0.7	243145.7	8.2
Hong Kong, China	0	81948.8	2.7
Malawi	6.5	59286.2	2.0
Japan	0.7	52652.6	1.8
Sudan	1.8	45737.1	1.5
South Africa	7.3	41801.6	1.4
Ethiopia	16.9	36857.6	1.2
Swaziland	5.4	35001.5	1.2
EAC	0	1287211.6	43.2
Top 10 plus EAC	4.2	2811304.0	94.3
Total exports		*2981364.1*	*100.0*

Source: TRAINS

Although most of the industrial products export destination markets are EAC Partner State countries themselves and the Common Market for Eastern and Southern Africa (COMESA), exports to some developed and some developing countries' markets are also significant.

Market Access conditions for EAC industrial products exports

EAC exports of industrial products to high income countries account for over 20% of the total industrial goods exports, while exports to all LDCs accounts to about 48% of the total EAC industrial goods exports. Altogether, the industrial goods exports to both developed and developing countries (other than EAC countries) account for about 53% of the EAC industrial goods exports.

Table 5.24 shows the major developing countries export destination markets for EAC industrial goods and the tariff rate conditions existing in these markets. `

Table 5.24: Top 10 developing countries exports destination markets

Reporter Name	Simple Average	No. of Total Lines	No. of Int'l Peaks	No. of Lines 20 to 50	No. of Lines 50 to 100	Imports Value (US$'000)	Dutiable (%)	Market share (%)
China	6.4	643	58	22	0	422444.9	7.7	80.4
South Africa	7.3	1930	326	197	2	41801.6	35.7	8.0
Swaziland	5.4	37	7	3	2	35001.5	0.0	6.7
Turkey	4.6	238	50	50	0	5974.0	51.0	1.1
Indonesia	6.7	48	2	2	0	4674.8	55.3	0.9
Mexico	8.1	1131	71	65	0	3705.6	71.7	0.7
Botswana	3.7	84	9	4	2	3669.0	1.8	0.7
Philippines	7.7	17	1	0	0	2344.2	100.0	0.4
Brazil	13.8	83	28	4	0	2122.9	100.0	0.4
Namibia	7.6	213	50	32	0	1265.8	89.2	0.2
Dominican Republic	5.9	66	13	0	0	964.0	9.8	0.2
Top 10	7.0	4490	615	379	6	523968.3		99.7
All developing countries	*7.45*	*5191*	*731*	*385*	*6*	*525633.0*	*11.9*	*100.0*

Source: TRAINS

In 2010, the main EAC industrial products developing countries exports destination markets of China, South Africa and Swaziland, accounting for 80, 8 and about 7, percent respectively of all industrial goods exported to all developing countries.

Tariffs faced by EAC industrial goods exports to developing countries are on average about 7.5 percent, with the highest tariffs of about 14percent being experienced in Brazil. Tariff reduction in developing countries' export destination markets for EAC countries presents an opportunity for EAC countries to improve their market access and exports.

Table 5.25 shows the export destination markets for EAC's industrial products in the Least Developed Countries (LDCs) and the market access conditions in these markets. Industrial goods exports to Burundi, Rwanda, Tanzania and Uganda account for about 87 percentage points of all exports to LDC countries and are treated duty free under the EAC Customs Union provisions. Exports to other LDC countries face significant duty rates, although the value of exports to these markets is insignificant.

Table 5.25: EAC Industrial goods exports to Least Developed Countries (2010)

Reporter Name	Average Tariff (%)	No. of Free Lines	Imports Value (US$'000)	Dutiable Imports (%)	Market share (%)
Uganda	0	3176	460528.9	0.0	32.9
Rwanda	0	6504	391935.1	0.0	28.0
Tanzania	0	2235	274602.2	0.0	19.6
Burundi	0	1124	81894. 3	0.0	5.9
Malawi	6.5	1100	59286.2	1.3	4.2
Sudan	1.8	161	45737.1	0.2	3.3
Ethiopia	16.9	43	36857.6	2.6	2.6
Mozambique	5.9	164	31939.5	1.4	2.3
Madagascar	0.03	180	8217. 7	0.0	0.6
Comoros	7.8	68	4161.2	0.0	0.3
Guinea	13.9	1	949. 3	0.1	0.1
Burkina Faso	15.9	0	371.1	0.0	0.0
Senegal	14.3	1	363.5	0.0	0.0
Benin	12.9	2	287.1	0.0	0.0
Top 14	6.9	14759	1397130.6	5.6	99.9

All exports to LDCs	*1.81*	*14774*	*1397947.2*	*5.8*	*100.0*

Source: TRAINS

Since in the current WTO NAMA proposals LDCs are except from tariff reductions, no market access gains for EAC industrial products in these markets as a result of the NAMA negotiations.

Table 2.26 shows the EAC industrial goods exports market access conditions in the developed countries.

Table 2.26: EAC Industrial products exports to developed countries (2010)

Export destination market	Simple Average	No. of Free Lines	No. of International Peaks	Imports Value US$'000	Free Imports (US$ '000)	Dutiable Imports (%)
United States	0.7	1224	16	243145.7	242150.4	0.4
Hong Kong, China	0.0	435	0	81948.8	81948.8	0.0
Japan	0.7	152	1	52652.6	41878.5	20.5
Singapore	0.0	295	0	21558.8	21558.8	0.0
Korea, Rep.	4.7	404	32	13131.0	12419.1	5.4
Australia	2.4	85	0	6403.2	5576.0	12.9
Canada	2.9	621	69	4319.5	2740.1	36.6
Norway	0.1	253	0	1016.5	1015.3	0.1
Switzerland	0.0	189	0	768.2	754.3	1.8
New Zealand	2.3	150	0	513.1	362.9	29.3
All developed countries	*1.5*	*3893*	*119*	*425596.9*	*410445.1*	*3.6*

Source: TRAINS

EAC exports to most of the developed countries have duty-free market access conditions, with an average of 3.6 percent of the exports to these markets facing an average duty of about 1.5%. Significant proportion of exports to Canada, New Zealand and Japan (about 37, 29 and 20%, respectively) face relatively low duty as shown in Table 6.

Tariff reduction in the developed countries is expected to lead to increased market access (and therefore a possible increase in exports of industrial goods)

for EAC industrial products in those developed countries where EAC products face tariffs on their exportation.

5.1.1.5. Concerns for EAC

The ongoing WTO NAMA negotiations when completed will lead to tariff reduction in industrial goods including goods of export interest to EAC Partner State countries. Tariff reduction by developed countries and developing countries present an opportunity for EAC industrial goods as they may lead to more market access for EAC industrial goods in countries reducing tariffs under the WTO NAMA negotiations. Tariff reduction also presents a challenge for EAC countries as it may lead to loss in EAC exports of manufacturing goods as a result of increased competition for EAC products in countries where EAC products benefit from preferential market access provisions due to loss in preferential margin (preference erosion).

What are the market access implications for these negotiations for EAC Partner State countries manufactured goods exports? Which products are likely to get increased market access, and in which export destination markets? This study will attempt to answer these questions.

This chapter analyses the impact of WTO NAMA negotiations on EAC exports of manufactures. More specifically, the chapter analyses the trade effects of both developed and developing countries reducing their tariffs under the current NAMA negotiations proposals on EAC industrial goods exports. It also identifies EAC countries' manufacturing products most affected by the tariff reduction (most positively and negatively) in both developed and developing countries markets.

The findings are useful to EAC Partner States WTO negotiators and policy makers with respect to the implementation of the EAC Industrial Policy and Strategy. The results show the prospects of increased market access for various EAC manufactured products exports in different markets.

5.2. Recent studies on impact of the WTO Doha

Studies such as those by Tangermann (2002); Yongzheng (2005); WTO (2005); Rahman and Shadat (2006), on the effect of NAMA negotiations on developing countries have shown that many developing countries and Least Developed Countries especially in Africa are likely to experience decrease in exports to developed country markets. This has been attributed to loss in preferences (reduction in preference benefit) as developed countries reduce their MFN tariffs.

The study by WTO (WTO, 2005) further found that African countries are likely to experience most preference erosion in the in EU, USA, Canada, Japan and Australia, with the products likely to be most affected being textile, fish and fish products, leather and leather products, electrical machinery and wood and wood products. The study further found that Kenya is likely to face preference erosion of US$M 26.4 as a result of these developed countries reducing their MFN tariffs. A similar study by EIA (2007) showed that with multilateral tariff reduction under the current ongoing WTO NAMA negotiations, Kenya is like to lose trade in various export destination markets for her manufactured products. Most loses were likely to be experienced in the EU and USA markets, where the country exports under preferential trade regimes. The study also found that fisheries and textile and related products were the products likely to lose most in these markets.

A study on the impact of Doha (Zepeda, el,. Al, 2009), analyzed the likely impact of the current Doha agreements (under negotiation) including reduction of subsidies by developed countries, and reduction of tariffs by both developed and developing countries, on Kenya. The study found that Kenya is likely to gain in agricultural products and processed foods but is likely to lose in the manufacturing and mining sectors. On overall, the study found that liberalization of goods trade will lead to a slightly annual increase of Kenya GDP of 0.2 percent.

5.3. Methodology

From an exporting country point of view, the effect of a tariff being implemented by large importing country (Home) is like a cost of transportation. The theoretical effects (trade, price and welfare) of a tariff by a large importing country to both home and foreign country has been illustrated by Suranovic (2010) and Krugman, Obstifeld, and Melitz (2012). When a large country (home) implements a tariff, exporters (foreign country) will be unwilling to export unless the price difference between the two markets is at least the size of the tariff (in specific terms). In the absence of a tariff, the price would be equalized at world price in both Home and Foreign country. In presence of a tariff, exporters are not willing to export to Home country unless the Home price exceeds their (Foreign country) price by at least the size of the tariff.

Without exports, there will be an excess demand in Home country and an excess supply in foreign country. The price in Home will therefore rise while that in Foreign country will fall. A tariff, therefore, causes a difference between the prices in the two markets. The tariff raises the price in Home while it lowers the price in Foreign (albeit very small in practice). In Home, producers supply more at the higher price, while consumers demand less, so that fewer imports are demanded. In Foreign on the other hand, the lower price leads to reduced supply and increased demand, and therefore a smaller export supply leading to lower volumes being traded.

Thus an import duty (by an importing country) hurts the economy of the exporting country. A foreign tariff raises the costs of domestic (exporting country) producers which causes them to sell less in those foreign markets. Producers in the exporting country cut production due to this reduction in foreign country demand. Foreign tariffs, in addition to other types of market restrictions, may lead to a decline in a country's welfare, while tariff elimination may lead to welfare increase. Presence of tariffs in the EU (large economy) industrial goods, affects

prices, export quantities and welfare from exports of industrial goods in the respective countries.

The effects of trade tariff preferences granted by an importing country (Home) on the exporting country (Foreign) is exactly the opposite of the impact of a tariff: it lowers foreign country's costs of exporting and causes it to sell more in the preference granting country's markets.

In this chapter, we use the SMART model, -an ex-ante partial equilibrium model embedded in World Integrated Trade Solution (WITS) data retrieval system to simulate the overall effect of WTO MFN reduction using the current NAMA proposals on non agricultural products exports for EAC Partner State countries.

The model allows estimation of the impact of tariff reductions on trade flows, tariff revenue, and consumer surplus for a single market at a time (Laird and Yeats, 1986). The uses of the model include: making projections on impact of preferences on level and structure of trade between countries, studying how specific products will be affected by different trade policies, studying the effects of existing trade preferences, and evaluating how trade policies (such as liberalisation) affect countries. Recently, the model has been used to analyse the impacts of MFN tariff cuts on trade value (Yeats, 1994; ECA, 2006). Model was also used to estimate trade changes as a result of a free trade area between European Union and South Africa (Jachia and Teljeur, 1999). Makochekanwa, (2012) has also recently used the model to analyse the welfare and food security implications of the COMESA-EAC-SADC tripartite free trade area.

The two main advantages of the partial equilibrium are the minimal data requirement and provision of an analysis at a fairly disaggregated (or detailed) level. Data required include data on trade flows, the trade policy (tariff), and supply and demand elasticities.

5.3.1. Estimation of trade flow effects

We analyse the impact of tariff reduction at the WTO on EAC countries non-agricultural products. Recently proposed Swiss formula coefficients of 8 for the developed countries and coefficients of 20 or 22 or 25 for the developing countries were used (WTO (2008).

Our estimations are based on the export market destinations for EAC Partner States countries non agricultural products in both developed and developing countries. The coefficients used in the analysis are 8 and 19 for developed and developing countries respectively. Estimation of effects of total elimination of tariffs on EAC industrial products exports to both developed and developing countries are also done. Tariff cuts are applied on all non agricultural product exports of EAC Partner State countries.

The total effect of multilateral MFN tariff reductions at the WTO on EAC Partner States' non agricultural product exports to specific markets is presented in the model as the sum of trade creation and trade diversion.

5.3.2. Estimation of trade creation

Trade creation provides a projection of increase in specific markets imports of non agricultural products from each EAC Partner State in relative price of these imports in a specific market domestically produced non agricultural products. This leads to a net increase in a specific market's total imports and a net decrease in the same market's domestic production. The main assumption in this case is that there is a full transmission of changes of multilateral MFN tariffs reduced.

Trade creation (*TC*) for product *i* exported from country *k* to country *j* is estimated as:

$$TCijk = \frac{Mijk \times Em \times dtijk}{[(1 + tijk) \times (\frac{Em}{Ex})]} \quad \text{..2}$$

Where:

M ijk is the Imports of non agricultural product *i* by trading partner country *j* from each of the EAC Partner State country (*k*) ,

Em is the elasticity of import demand with respect to domestic price of the importing country,

Ex is the elasticity of export supply with respect to export price of EAC Partner State,

tijk is tariff rate faced by non agricultural product *i* when exported by EAC Partner State to country *j*.

dtijk is the change in tariff rate faced by non agricultural product *i* when exported by EAC Partner State to country *j*.

5.3.3. Estimation of trade diversion

Trade diversion is a measure of increase in the particular market's import of non agricultural products from EAC Partner State country due to decrease in relative prices of these products in relation to imports from the rest of the world. The imports to the particular market increase at the expense of the imports from the rest of the world without changes in total exports. The trade diversion (*TD*) caused by a non agricultural product *i* exported from EAC Partner State country (*k*) to market *j* was estimated in the model as:

$$TDijk = TCijk \times [\frac{Mnij}{Vij}] \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots.3$$

Where:

TCijk is the trade creation by non agricultural product (*i*) exported by EAC Partner State country (*k*) to country *j*.

Mnij is the imports by country *j* of non agricultural product *i* from non-preference-benefiting countries

Vij is the output of non agricultural product *i* in the importing country *j*.

5.3.4. Estimation of elasticity of import demand

Elasticity of import demand ($\dfrac{dMijk}{Mijk}$) of the non agricultural product *i* exported from EAC Partner State country into export destination market *k* (assuming substitutability between EAC's country of non agricultural products and similar products from the rest of the world) is estimated in the model as:

$$\frac{dMijk}{Mijk} = Em[\frac{dtijk}{\{(1+tijk)+(\dfrac{dPijk}{Pikj})\}}] \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots.4$$

Where:

Em is the elasticity of import demand with respect to domestic price of the export destination market,

tijk is the tariff rate faced by product I in export market j when exported from EAC country,

dtijk is the Change in tariff rate is the tariff rate faced by product I in export market j when exported from EAC country,

Pikj is the- price of non agricultural product i from EAC country in export market j,

dPijk is the change in price of non agricultural product i from EAC country in export market j.

5.3.5. Estimation of elasticity of export supply

The model estimates the elasticity of export supply of non agricultural product *i* exported from Kenya (*k*) to market *j* would be estimated as shown in equation 4:

$$\frac{dMijk}{Mijk} = \frac{dXikj}{Xikj} \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots.5$$

Where:

Mijk is the imports of non agricultural product *i* from Kenya by country *j* ,

dMijk is the change in imports of non agricultural product *i* from EAC Partner State country by country *j*,

Xikj is the exports of non agricultural product *i* by *j* to *k*,

dXikj is the change in the exports of non agricultural product *i* by *j* to *k*.

The model assumes elasticity of supply at infinity.

5.3.6. Estimation of total trade effect

The effect of multilateral reduction and elimination of tariffs at the WTO on total non agricultural products exports from each of the EAC Partner State country to a specific export destination market was estimated as the sum of trade creation and trade diversion.

5.3.7. Assumptions of the model used in this analysis

Three main assumptions we made in this analysis (generally assumptions of the SMART model):

  i. Export supply elasticities are infinite. This is because EAC Partner States are small economies by global economy standards. This is the price taker assumption.

ii. Armington assumption on substitutability for export supply, which means that exports of different countries, although similar, are imperfect substitutes.

iii. Import substitution elasticity of 1.5, implying that similar products from different countries are imperfect substitutes.

5.3.8. Data types and sources

Data sets used for the analysis were obtained from the UNCTAD's Trade Analysis and Information System (Trains). Data used was for the year 2010. Using the same data source, EAC countries trade in industrial goods and the respective market conditions (particularly both MFN and the preferential tariffs rates) were analysed.

Simulations were also done to estimate the trade effect when MFN tariffs are reduced using Swiss formula with coefficients of 8 the developed countries and using a coefficient of 22 for developing countries respectively. The simulations were done for all non-agricultural products exports markets for EAC countries (developed and developing markets separately). Both developed and developing countries (with some exceptions), are expected to cut their non-agricultural products tariffs during the on-going Doha Round of negotiations.

Products which are likely to be most affected in both developed and developing country's markets were also identified.

5.4. Effects of Tariff reduction at the multilateral level

5.4.1. Effects of Tariff reduction by developed countries

Trade flow effects of reducing tariffs using a coefficient of 8 in developed countries on EAC industrial goods exports are discussed below. Table 5.27 summarizes the results of tariff reduction simulation using a coefficient of 8 by developed countries on EAC industrial goods exports.

Developed countries which are EAC Partner States industrial goods export destination markets analysed are: European Union, USA, Japan, Canada, Australia, Norway, Switzerland and New Zealand.

Table 5.27: Effects of developed countries reducing tariffs on EAC Countries' manufactures exports

Developed country	Old Simple Duty Rate (%)	New Simple Duty Rate (%)	Exports Before in '000 USD	Exports After in 1000 USD	Export Change '000 USD	Export Change (%)
European Union	0	0	505216.9	487837.6	-17379.3	-3.4
USA	1.5	0.6	243145.7	228287.9	-14857.8	-6.1
Japan	0.3	0.2	52652.6	52524.4	-128.2	-0.2
Canada	1.1	0.4	4319.5	4503.3	183.9	4.6
Australia	0.8	0. 5	1600.8	1605.7	4.9	0.3
Norway	0.0	0.0	1016.5	1016.1	-0.4	0.0
Switzerland	0	0	754.3	754.7	0	0
New Zealand	0.7	0.4	511.9	514.4	2.4	0.7
All	*0.6*	*0.35*	*809218.3*	*777043.7*	*-32174.6*	*-3.9*

Source: TRAINS

With multilateral MFN tariff reductions in the developed countries, EAC countries likely experience both gains and losses in value of industrial exports to these markets. Combined, the overall effects a likely loss of bout US$ B 32 of trade value per year (representing about 4 percentage loss of the current trade value per year).

Collectively, EAC Partner State countries are likely to gain market access and therefore are likely to increase their exports of industrial goods in Canada and Australia markets. In these markets, most of the EAC industrial goods exports face some tariff (though relatively low). EAC exports of industrial goods to Australia, Canada and New Zealand are under the Generalized System of preferences trading regime, providing tariffs lower than the MFN for the developing countries.

Tariff reduction in Norway and Switzerland presents no additional market access to EAC Partner States because the pre-reduction tariff levels are already too low, indeed zero, for all countries exporting to those markets. In this case, there is no change in value of trade due to tariff reduction for the EAC countries.

For EU, tariffs on industrial goods from EAC are also zero as the two regions are trading under the EAC-EU Framework Economic Partnership Agreement (FEPA) preferential regime. There is no expected gain in market access as a result of tariff reduction. Tariff reduction of the MFN tariff levels however lowers tariffs for other (non EAC countries) currently facing tariffs in the EU, therefore lowering the leverage for the EAC countries in the EU market. The effect of this is that EAC countries are likely to loss over 3% of the value of their current export value to the EU market. This loss is due to preference erosion, the loss in preference benefit due to EU cutting tariffs for the third countries.

Most of the EAC industrial goods exports to USA and Japan also face low duty levels, as exports to these markets are under the Generalized System of Preferences (GSP) Schemes. In addition, most of the EAC industrial products exports to USA are under the African Growth and Opportunity Act (AGOA) trading regime. MFN Tariffs reduction in USA and Japan lead to loss in value of EAC Partner States industrial goods exports, due to loss in preferences due to the GSP and AGOA trading arrangements.

The largest loses equivalent to 6 percent of the current EAC trade is likely to be experienced in the USA market, with Kenya experiencing the largest loss of an equivalent 6.7 percent of her current trade value. Tanzania experiences the smallest loss of 0.3 percent of her current trade value with USA. Burundi is likely to gain in the USA market, an equivalent of 1 percentage point of her current value of trade with USA (Table 5.28).

Table 5.28: Change in manufactured goods exports of different EAC countries and different export markets (%)

Developed country	Old Simple average tariff	New Simple average duty rate	Burundi	Kenya	Rwanda	Uganda	Tanzania	Total EAC
USA	1.5	0.6	1.0	-6.7	-0.4	-1.3	-0.3	-6.1
Japan	0.3	0.8	-4.0	0.8	-1.0	-0.3	-0.2	-0.2
Canada	1.1	0.4	-1.0	9.1	-1.6	-0.1	-2.0	4.3
Norway	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.0
Australia	0.8	0.5	0.6	-0.2	-2.3	-0.1	0.3	-1.7
New Zealand	0.7	0.4	0.0	1.9	-1.2	-0.4	-0.7	0.5
EU	0	0	-1.1	-3.2	-0.8	-3.3	-4.0	-3.4
Switzerland	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: TRAINS

Kenya products most likely to loss out in the USA market as a result of tariff reduction are presented in Table 5.29.

Table 5.29: Kenya products affected in the USA market

HS code	Product name	Old Simple Duty Rate	New Simple Duty Rate	Trade Total Effect (US$'000)	Price Effect	Trade Creation Effect (US$'000)	Trade Diversion Effect (US$'000)
620462	Women's or Girls' Trousers, Breeches, of Cotton	0	0	-3096.7	0	0	-3096.7
610462	Women' trousers, breeches and girls' No.7 No.16, knitted or crocheted, of cotton	0	0	-2093.4	0	0	-2093.4
611020	Sweaters, Pullovers, Sweatshirts, Waistcoats (Vests), Knitted or Crocheted, of Cotton	0	0	-1637.0	0	0	-1637.0
611030	Sweaters, Pullovers, Sweatshirts, Waistcoats (Vests), Knitted or Crocheted, of Manmade Fibers	0	0	-1130.5	0	0	-1130.5
620342	Men's or Boys' Trousers, Overalls, Breeches, of Synthetic	0	0	-1019.5	0	0	-1019.5

	Fibres						
610343	Men's or Boys' Trousers, Overalls, Breeches, of Synthetic Fibres	0	0	-827.6	0	0	-827.6
620920	Babies Garments and Clothing Accessories, of Wool or Fine Animal Hair	0	0	-790.4	0	0	-790.4
610520	Men's or Boys' Shirts of Man-made Fibres, Knitted or Crocheted	0	0	-696.7	0	0	-696.7
611120	Babies' Garments and Accessories, of Cotton, Knitted or Crocheted	0	0	-603.5	0	0	-603.5
610463	Women's Trousers, Breeches, of Synthetic Fibres, Knitted or Crocheted	0	0	-592.4	0	0	-592.4
All Industrial products		0.6	0.3	-14670.8	0	32.0	-14702.8

Source: TRAINS

These comprise products of the Hs chapter classifications 61-62 (Articles of apparel and clothing accessories, knitted or crocheted and articles of apparel and clothing accessories not knitted or crocheted), which are exported to USA under the AGOA trading regime on a duty free basis. MFN tariff reduction in these products are likely to improve market access for the countries currently exporting at higher MFN tariff levels, while reducing the AGOA preferential benefits for the EAC countries. Trade is diverted from EAC countries to those countries which now have improved market access and an improved competitiveness in the same market.

On average the EAC countries are likely to loss trade as a result of EU cutting MFN tariffs under the on-going NAMA negotiations. The total loss in trade value for the region represents some 3.4 percent of the current region's trade. Of the EAC Partner State countries, Rwanda is likely to experience the smallest loss of about 0.8 percentage points of her current trade value while Tanzania is likely to face the largest loss accounting in the region accounting for some 4percentage points of her current manufactured goods value to EU.

In Rwanda some products will not gain while others are likely to lose out in the EU market as a result of multilateral tariff reductions. Those likely to lose if EU reduces tariffs under the ongoing multilateral negotiations are shown in Table 5.30.

Table 5.30: Rwanda industrial products exports most affected if EU cuts MFN tariffs

Hs Code	Product name	Old average Duty Rate (%)	New average Duty Rate (%)	Trade Total Effect ('000 US$)	% change	Trade Creation Effect ('000 US$)	Trade diversion ('000 US$)
380891	(2007-) (- Other:)-- Insecticides	0	0	-8.0	-5.4	0	-7.9
851770	(2007-) - Parts	0	0	-1.5	-1.7	0	-1. 5
442010	Statuettes and other ornaments, of wood	0	0	-1.1	-2.8	0	-1.0
871499	Other	0	0	-1.0	-6.6	0	-1.0
711790	Other	0	0	-1.0	-5.5	0	-1.0
840999	Other	0	0	-0.8	-2.5	0	-0.8
732690	Other	0	0	-0.7	-2.9	0	-0.71
460219	(2007-) (- Of vegetable materials:)-- Other	0	0	-0.7	-4.6	0	-0.7
410411	(2002-) Full grains, unsplit; grain splits	0	0	-0.7	-1.3	0	-0.7
940389	(2007-) (- Furniture of other materials, including	0	0	-0.6	-7.4	0	-0.6
All Industrial products		*0*	*0*	***-20.2***	*-0. 8*	*0*	*-20. 2*

Source: TRAINS

The EAC country whose exports are likely to be affected most (most decrease) if EU cuts tariffs under the ongoing multilateral negotiations is Tanzania. Non agricultural exports from Tanzania to EU are likely to reduce by about 4 percentage points. Table 5.31 shows the products likely to be most affected.

Of the most affected products, most of them are in the fishes and related products, which constitute a large proportion of industrial products exports from all EAC Partner State countries.

Table 5.31: Tanzania most affected products by EU tariff reduction

Product Code	Product name	Old average Duty Rate (%)	New average Duty Rate (%)	Trade Total Effect ('000 US$)	% change	Trade Creation Effect ('000 US$)	Trade diversion Effect ('000 US$)
30419	(2007-) (- Fresh or chilled:)-- Other	0	0	-3273.7	-4.5	0	-3273.7
30429	(2007-) (- Frozen fillets:)-- Other	0	0	-859.1	-6.7	0	-859.1
30379	Other	0	0	-540.8	-6.4	0	-540.8
30269	Other	0	0	-481.3	-4.2	0	-481.3
410621	(2002-) In the wet state (including wetblue)	0	0	-12.4	-1.4	0	-12.4
851770	(2007-) - Parts	0	0	-11.2	-1.7	0	-11.2
711790	Other	0	0	-8.6	-5.5	0	-8.6
880330	Other parts of aeroplanes or helicopters	0	0	-5.7	-1.2	0	-5.7
390690	Other	0	0	-4.9	-5.2	0	-4.9
30499	(2007-) (- Other:)-- Other	0	0	-4.7	-6.8	0	-4.7
All Industrial products		*0*	*0*	*-5275.1*	*-4.0*	*0*	*-5275.1*

Source: TRAINS

The largest gains for EAC countries as a whole are likely to be experienced when Canada reduces tariffs. Of the EAC Partner State countries, Kenya is likely to gain the most when Canada cuts tariffs under the on-going WTO negotiations. Kenya products likely to gain most are presented in Table 5.32.

The products likely to gain are all of category of the articles of textiles and apparel accessories not knitted or crocheted as shown in Table 5.32. These products are likely to gain market access to Canada, because currently they

face relatively high tariffs on Canadian market of above 10%. Using a coefficient of 8%, tariffs reduce to less than 6% presenting an increased market access for such Kenya products.

Table 5.32: Kenya products likely to gain when Canada reduces tariffs

Product Code	Product name	Old average Duty Rate (%)	New average Duty Rate (%)	Trade Total Effect ('000 US$)	% Change	Trade Creation Effect ('000 US$)	Trade Diversion Effect ('000 US$)
620462	Of manmade fibres	17	5.4	78. 9	17.7	58.2	20.7
620342	Of manmade fibres	17	5.4	38.9	19.1	23.9	14.9
611030	Of cotton	18	5.5	12.5	13.6	9.2	3.3
620520	Of manmade fibres	17	5.4	9.8	15.0	8.1	1.7
611020	Of synthetic fibres	18	5.5	9.7	11.6	6.6	3.1
610620	Of manmade fibres	18	5.5	5.4	45.8	4.8	0. 6
620343	Of cotton	18	5.5	4.0	13.8	2.7	1.3
610520	Of synthetic fibres	18	5.5	3.8	14.2	2.7	1.1
611430	Of cotton	18	5.5	3.6	13.9	2.4	1.2
611130	Of cotton	18	5.5	2.9	20.9	2.5	0.5
All industrial products		*5.9*	*2.2*	*199.7*	*9.1*	*142.9*	*56.6*

Source: TRAINS

Of all the EAC Partner State countries' exports to Canada, Tanzania is likely to lose most in the Canadian market as a result of Canada reducing her tariffs at the multilateral level. Table 5.33 shows the Tanzania industrial products exports to Canada which are likely to be affected the most if Canada reduces her tariffs on industrial goods under the current WTO proposals.

Table 5.33: Tanzania industrial products exports to Canada likely to be affected most

Product Code	Product name	Old average Duty Rate	New average Duty Rate	Trade Total Effect ('000 US$)	% change	Trade Creation Effect ('000 US$)
610910	Of cotton	0	0	-8.7	0	-8.7
610990	Of other textile materials	0	0	-1.6	0	-1.6
640399	Other (footwear, with outer soles of rubber, plastics)	0	0	-0.9	0	-0.9
610343	Of synthetic fibres	0	0	-0.7	0	-0.7
620520	Of cotton	0	0	-0.5	0	-0.5
611030	Of manmade fibres	0	0	-0.4	0	-0.4
611430	Of manmade fibres	0	0	-0.3	0	-0.3
611020	Of cotton	0	0	-0.3	0	-0.3
620799	Of other textile materials	0	0	-0.2	0	-0.2
610463	Of synthetic fibres	0	0	-0.1	0	-0.1
All industrial products		*0*	*0*	*-14.0*	*0*	*-14.0*

Source: TRAINS

The products likely to be most affected are mainly textiles and apparels currently facing a duty rate of 0, for which Tanzania exports to Canada under the Canadian duty free and quota free access trading arrangement, provided under the LDC preferential tariff (LDC-PT) granted by Canada to all LDCs. Multilateral tariff reduction by Canada will therefore lead to reduction in the preferential tariff benefit for Tanzania (preference erosion) and to a likely less exports of the same products by Tanzania as other countries get better leverage with multilateral tariff reduction.

5.4.1.1.   Impact of tariff cuts in developing countries

Simulation results of developing countries reducing tariffs on industrial goods using a coefficient of 22 on EAC countries' exports of industrial goods are presented in Table 5.34. China is among developing countries which present a

significant export destination market and who are not expected to reduce tariffs using the Swiss formula under the on-going WTO NAMA negotiations. China is therefore not included in the simulations.

Table 5.34: Trade effects of developing countries reducing tariffs on EAC industrial goods exports

Developing country	Old simple duty rate (%)	New simple duty rate (%)	Exports before (US$'000)	Exports after (US$'000)	Export change in revenue (US$'000)	% change in exports
Swaziland	7.4	4.2	35001.5	34976.9	24.6	0.1
South Africa	5.8	3.2	41801.6	41621.5	-180.1	-0.4
Brazil	10.7	9.0	2122.9	2133.3	10.4	0.5
Dominican Republic	5.0	8.1	964.0	964.1	0.1	0.0
Indonesia	6.8	5.6	4674.8	4683.5	8.7	0.2
Mexico	6.7	4.5	3705.6	3958.9	253.3	6.8
Namibia	12.3	6.8	1265.8	1285.1	19.4	1.5

Source: TRAINS

The largest gains in market access and therefore in increase in exports values for EAC countries of about 7 percentage points are likely to be experienced in Mexico. Largest loss in market access and therefore loss in value of EAC countries' exports is likely to be experienced in South Africa.

Kenya is likely to gain the most in Mexico market than any other EAC Partner State country, with her exports in manufactured goods being likely to increase by about 12% as a result of the increase in market access with Mexico reducing her import duty (Table 5.35).

Burundi and Tanzania are also likely to increase their exports of industrial goods to Mexico by about 6.5 and 0.4 percentage points respectively. For Rwanda and Uganda, there is likely to be no change in industrial exports to these markets.

Table 5.35: Changes in EAC industrial goods exports in Mexico

EAC Partner State	Old Average duty rate (%)	New Average duty rate (%)	Exports before (US$ '000)	Exports after (US$ '000)	Export change (US$ 000)	Export change (%)
Kenya	9.2	6.2	2132.9	2381.4	248.5	11.7
Burundi	16.0	9.0	30.9	32.9	2.0	6.5
Tanzania	1.4	1.4	714.1	716.9	2.8	0.4
Rwanda	4.2	3.2	3.8	3.8	0.0	0.0
Uganda	2.9	2.8	823.9	823.9	0.0	0.0
Total	6.7	4.5	3705.6	3958.9	253.3	6.8

Source: TRAINS

Products from Kenya likely to gain in the Mexico market, when Mexico reduces her tariffs are shown in Table 3.16. All the important market access beneficiary products are likely to be of the textiles and apparels category.

Table 5.36: Kenya: Main products likely to gain in Mexico market

Hs Code	Product name	Old average duty rate (%)	New average duty rate	Trade Total Effect (US$'000)	Trade Creation Effect (US$'000)	Trade Diversion Effect (US$'000)
620462	Of cotton	30	13.5	112.6	90.8	21.8
610343	Of synthetic fibres	30	13.5	60. 5	55.0	5.4
610130	Of man-made fibres	30	13.5	54.2	51.2	2.9
620343	Of synthetic fibres	30	13.5	12.1	5.9	6.2
610620	Of manmade fibres	30	13.5	2.3	1.7	0.7
610990	Of other textile materials	30	13.5	1.6	0.9	0.6
620342	Of cotton	30	13.5	1.4	0.9	0.5
620463	Of synthetic fibres	30	13.5	0.7	0.5	0.2
610443	Of synthetic	30	13.5	0.6	0.5	0.1

	fibres				
620113	Of man-made fibres	30	13.5	0. 6	0.4	0.2
All industrial products		*16.0*	*8.9*	*248.5*	*209.4*	*39.1*

Source: TRAINS

The largest loses are likely to be experienced in South Africa, where the EAC region is likely to lose about 0.4% of its current value of manufactured exported to South Africa Table 17. The country likely to be most affected is Tanzania, losing an equivalent of 3 percent of her current manufactured goods exports value to South Africa, as shown in Table 5.37.

Table 5.37: Change in exports to South Africa

EAC Partner State	Tariff before	New tariff	Exports before (US$ '000)	Exports after ('US$ 000)	Export change in revenue ('US$ 000)	% Change in exports
Kenya	7.9	3.6	25253.6	25491.2	237.6	0.9
Burundi	12.6	6.3	4.0	4.1	0.1	1.8
Rwanda	2.8	2.4	97.9	99.3	1.4	1.5
Tanzania	0.0	0.0	14365.9	13940.2	-425.7	-3.0
Uganda	5.9	3.8	2080.2	2086.8	6.5	0.3
Total	5.8	3.2	41801.6	41621.5	-180.1	-0.4

Source: TRAINS

Apart from Tanzania, the other EAC Partner State countries are likely to gain through increased market access as South Africa reduces her tariffs. The value of Burundi's exports to South Africa may increase by about 2% as a result of this increased market. The value of Kenya, Rwanda and Uganda industrial goods exports could also increase by about 1, 1.5 and 0.3 percentage points respectively if South Africa reduces tariffs in her industrial goods in line with the current WTO NAMA proposals at the WTO.

The products likely to be most affected in Tanzania are shown in Table 5.38. The products are mainly textiles and apparels and currently face a duty rate of 0 as Tanzania exports them under the Southern Africa Development Community (SADC) trading arrangements. South Africa tariff reduction at the multilateral level leads to erosion of preferences in Tanzania, increasing the leverage level of exporters of similar products to South Africa currently being exported under MFN tariff levels.

Table 5.38: Tanzania export products most affected in South Africa market

HS code	Product name	Old tariff	New tariff	Trade Total Effect (US$ '000)	Trade Creation Effect US$ '000	Trade Diversion (US$ '000)
610910	Of cotton	0	0	-293.5	0	-293.5
610510	Of cotton	0	0	-32.9	0	-32.9
620630	Of cotton	0	0	-22.0	0	-22.0
630221	Of cotton	0	0	-16.8	0	-16.8
620329	Of other textile materials	0	0	-13.3	0	-13.3
620462	Of cotton	0	0	-8.3	0	-8.3
610610	Of cotton	0	0	-6.8	0	-6.8
620520	Of cotton	0	0	-4.5	0	-4.5
330499	Other (Creams and other preparations with a basis of oil, fat or wax)	0	0	-4.1	0	-4.1
630251	Of cotton	0	0	-3.3	0	-3.3
All industrial products		*0*	*0*	*-425.7*	*0*	*-425.7*

Source: TRAINS

Kenya industrial products likely to gain most in South Africa market are shown in Table 5.39. Most of these products face a significant tariff in South Africa and tariff reduction will significantly reduce this tariff creating trade for Kenya. Cotton, textiles and apparels account for the products likely to gain most.

Table 5.39: Kenya products most likely to gain in South Africa market

HS Code	Product name	Old average duty rate (%)	New average duty rate (%)	Trade Total Effect(US$ '000)	Trade Creation Effect (US$ '000)	Trade Diversion Effect (US$'000)
283620	Disodium carbonate	5.5	4.4	94.9	94.9	0.0
520515	Measuring less than 125 decitex (exceeding 80 metric number-Cotton)	15.0	9.8	33.5	33.5	0.0
620462	Of cotton	45.0	14.8	21.1	20.8	0.4
841829	Other	25.0	12.7	18.2	16.6	1.6
870323	Of a cylinder capacity exceeding 1,500 cc but not	23.5	15.3	11.5	6.2	5.4
610349	Of other textile materials	45.0	14.8	5.3	5.3	0.0
640299	Other (other footwear with outer soles and uppers of rubber)	30.0	12.7	3.9	3.8	0.0
520949	Other fabrics	22.0	11.7	3.3	2.9	0.4
520832	Plain weave, weighing more than 100 g/m2	22.0	11.7	3.0	2.7	0.3
442010	Statuettes and other ornaments, of wood	30.0	12.7	2.8	2.1	0.7
All industrial		*12.6*	*6.3*	*237.6*	*223.7*	*13.9*

Source: TRAINS

5.5. Concluding remarks

In this chapter, we have analyzed the trade effects of both developed and developing countries reducing their multilateral tariffs under the current NAMA negotiations on EAC industrial goods exports. The EAC countries' manufacturing products most likely to be affected by the multilateral tariff reduction (both positively and negatively) in both developed and developing countries markets under the current NAMA tariff reduction proposals have been identified.

Simulation of tariff reduction using the Swiss Formula with a coefficient of 8 for developed countries shows that EAC countries are collectively likely to lose a trade value representing about 4 percentage points of their current trade. Largest losses in trade of about 6 and 3 percentage points of the current trade value are likely to be experienced in USA and EU markets respectively. Tariff reductions in Canada are likely to increase market access for EAC industrial products and therefore likely to lead to increased EAC industrial products exports to that market.

Products likely to be affected most are exports of textiles and apparels, fisheries and products made up of leather. The same products enjoy preferential market access in EU and USA markets, while the MFN tariffs remain significantly high. Same products are likely to gain in Canada market where they are currently facing higher duty rates, whose reduction will present improved market access for these products.

Simulation results of developing countries reducing tariffs on industrial goods using a coefficient of 22 on EAC countries' exports of industrial goods show that collectively, EAC countries are likely to increase their market access and the value of exports to these markets as a result of the tariff reduction. The largest likely gains in market access and therefore likely largest increase in exports values for EAC countries of about 7 percentage points are likely to be experienced in Mexico. Largest loss in market access and therefore likely loss in value of exports is likely to be experienced in South Africa. Like in the case of

the tariff reduction in the developed countries, products likely to gain most are main those related to cotton, textiles and apparels.

From our findings, it is concluded that if the currently WTO tariff reduction proposals under the NAMA negotiations are to be implemented by both developed countries and developing countries, the immediate impacts include:

i.   EAC industrial goods exports to developed countries are collectively likely to decrease as EAC countries preferential benefits margin reduce as the MFN tariffs reduce.

ii.   EAC countries market access to Canada is likely to increase and therefore exports in this market are likely to increase.

iii. Products likely to loss or gain most in most developed countries are those with a larger preferential benefit margin particularly leather related products, fisheries and textiles and clothing, the same products are more protected in those markets through high MFN tariffs.

iv.   Collectively EAC countries exports to developing countries are likely to increase.

v.   The most likely affected products in the case of tariff reduction in developing countries are likely to be cotton, textiles and apparels.

Irrespective of the slow progress of the WTO Doha negotiations in general and NAMA negotiations in particular, it is important for EAC countries to prepare themselves for the effects of the multilateral tariff reductions under the WTO. EAC countries can take measures to reduce the likely negative effects likely to be incurred due to loss of preferential margin in the developed country markets. They should also take measures to position themselves to take advantage of the likely improved market access in developing countries as result of tariff reduction. To achieve these, the following recommendations are made:

i. Put measures in place to step up competitiveness of the manufacturing sector including the industrial sectors likely to be affected negatively in the developed countries identified above. Competitiveness of the manufacturing sector in EAC could be improved through taking measures to reduce production costs and to increase productivity of the manufacturing sectors.

ii. Seek to diversify export destination markets for industrial goods while reducing concentration in a few export markets currently providing preferential market access.

iii. Diversify export products and reduce dependence in a few products. Value addition presents a good opportunity for the region to diversify.

iv. Develop other manufacturing sectors for exports. The region has RCA for significant manufacturing sector products, showing that the region has a potential to develop those manufacturing sectors.

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CHAPTER 6

The Mineral and Oil Find in Kenya: Is it A Curse or a Blessing?

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6.1. Introduction

The presence of mineral in a country should be a boon to economic development. The returns from its exploitation can be used to promote economic growth by building the necessary infrastructures, generating employment, promoting the development of domestic skills, facilitating the creation of associated industries, and creating additional side effects or linkages that are beneficial to the local economy (Tilton, 1992). The prospects for economic growth therefore increases with higher quantity and quality of the mineral resources found.

The reality, however, is that, all metals and minerals are finite and once removed and processed; can neither be returned to their original state, nor can the area that hosted these deposits be left undisturbed (Moody, 2007). It is in this respect that every unit of the finite resources consumed today, reduces the amount available for future consumption of which, the classical examples are fossil fuels and mineral deposits. It is also against this backdrop that investments of the proceeds from the mineral exploitation should be made sustainable even after the mineral has run out.

Even though mineral resource endowment varies from country to country, the geography of these deposits tends to be in remote regions largely occupied by indigenous local communities who face great difficulties in coping with both local and global development trends. The geologists estimate mineral endowments with resources and resource deposits, while a country's mineral dependence is

assessed by three criteria in percentage terms which may be greater or equal to the quantity as shown, namely: mineral GDP/total GDP ≥8%; mineral exports /total merchandise exports ≥40%; and non-fuel mineral exports/total merchandise >10% (Maxwell, 2000). However the most important criterion for a country to be categorised as a highly mineral dependent economy is, if the ratio of the value added by its mineral production to the total GDP exceeds 80% (Davis, 1995). A country is also said to depend significantly on non-renewable resource when its minerals and energy accounts for 25% or more of its total merchandise exports.

When the structure of African countries exports is examined, the mineral or fuel exports as percentage to total merchandise exports are extremely high, sometimes as high as 99% as in the case of Nigeria, 92% in Angola, and 91% in Botswana. Within these parameters, Kenya cannot be considered as a mineral economy because the mining sector still accounts for approximately less than one percent of the GDP, and the mineral export sector also accounts for less than one percent of the total merchandise exports.

This is, however, this is set to change with the discovery of oil in the Turkana County, coal in the Kitui County, titanium in Kwale County, and rich iron ore deposits in many parts of the country, and in particular, the Taita Taveta County. The discovery of oil, gas, coal, iron ore, gold and other minerals will fundamentally change the mining picture in the country. But unlike other natural resources wealth, these resources are extracted but not produced. They are therefore less like a source of income and more like an asset (Humphrey's et al 2007)

The likely impact The Paradox is that, rather than creating prosperity, an abundance of natural resources has often led to lower rates of economic growth, lower levels of human development, and greater inequality and poverty (Sachs and Warner, 1995; Bulte et.al., 2005; Gylfasen, 2001). Therefore, many resource rich developing countries are said to suffer from resources curse. In

particular, countries rich in 'point source' resources namely oil, gas, minerals and plantation crops. Evidence shows that such countries developed much more slowly during the 1980s and 1990s than those countries rich in 'diffuse' natural resources such as cocoa, coffee and tea (Isham et al., 2002). The history of oil extraction in developing countries has somehow confirmed this view by creating poverty instead of yielding benefits as the fruits of the country's wealth accrue to a minority of the country's elite (Wesbrot et al 2006).

This paper analysesof the oil find in the Turkana County including other minerals, and examine whether it will make Kenya fall into the resource curse curse trap or what it needs to do to be able to escape the resource curse which has plagued African countries such as Nigeria, Angola and others, except Botswana. It is now common knowledge that communities who own the land or live close to the mining operations hardly benefit from mining activities due to a number of reasons, namely: Forced out migration; the heavy price of environmental pollution or degradation; and the outflows of benefits as the oil wealth leaves their region to the exclusive benefit of others. The mining regions and the indigenous people, end bearing the greatest negative costs of the mineral exploitation, as the transnational mining corporations still in the words of Andy Whitmore (2005) practise the same old and naked ambitions of robbing communities of their wealth and destroying their environment.

In attempting to address some of these issues, there is need to review some of the institutional requirements and the prevailing legal frameworks in the exploitation of Kenya's mineral resources. The paper is therefore organized into nine sections. Section I is the introduction, section II reviews Kenya's mineral potential and catalogues some of the known mineral deposits, and their possible common uses not only in terms of their exports, but in terms of striggering industrialization; where they are found and who owns them. Section III examines theoretical framework of the paper, including resource curse hypothesis. Section IV reviews literature that covers three pertinent questions: (i) can nature's gifts be bad for development? (ii) what are the causes of the resources curse? and (iii)

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how can a country escape from the resource curse? Section V examines the legal framework for mineral wealth exploitation. Section VI looks at the communities' rights and whether they have been upheld or abused. Section VII dwells on the environmental impact of mining and its effect on the communities while Section VIII looks at the perspective of the debate on whether the resource abundance will be a curse or a boon for Kenya, and what measures should be taken to improve the management of natural resources. The last section, section IX examines the possible way forward.

KENYA'S MINERAL POTENTIAL AND POSSIBLE USES OF THE MINERALS.

Kenya is a country blessed with a vast range of mineral resources whose proper exploitation could positively transform the economic development trajectory of the country. In most parts of the country, including what is considered largely as underdeveloped areas such as Turkana and Garissa, possesses proven deposits of mineral resources such as oil and natural gas, stretching from Isiolo, Kwale to Lamu. Even though the country has not been systematically and exhaustively explored, the preliminary results indicate that Kenya is emerging as a mineral producing economy by the discovery of minerals, oil and gas.

Gold is found in most counties stretching from Turkana to Kuria. If gold could be properly commercialized and utilized, counties such as Nandi, Siaya, Kakamega, Vihiga, Migori, Trans Mara, Turkana, Kuria and Bondo could undergo major economic transformations. On the other hand, Coal which has been found in Kitui and Mutito - known as the Mui Basin has been described as Africa's most coal-rich area. Apart from being used for power generating in most countries, it is also a key component for the smelting of iron ore and other minerals. China has already set a base in Kitui. Significant deposits of iron ore have been discovered on Taita Taveta, Kitui,Meru, Kilifi, Samia and Homabay. A steel industry for the manufacture of domestic items as well as the construction industries could easily be established, and would boost economic development.

Soda ash, which is a major mineral deposit in Kenya is still exported in its raw form from Lake Magadi in the Kajiado County. It is said to provide direct employment to about 500 people. The mineral is used in the manufacture of glass, salt, preservatives, detergents, chemicals and dyes among others. If its value addition activities could be undertaken at county level, a number of additional economic activities would be generated. Its production has been controlled by the International Chemical Industry (ICT) – a British mining company, which has since been taken over by TATA, the Indian company. The list of other useful minerals that are currently being exploited but not fully utilized includes: fluorspar, which is abundant in Kerio Valley as Fluorspar or fluorite is an industrial mineral which is used in the manufacture of lenses for microscopes and telescopes, fluorescent bulbs, smelting including aesthetic uses. Its exploitation in Kenya is currently controlled by the Japanese company.

Limestone which is synonymous with Kenya, is found nearly everywhere in the country. It is used in the manufacture of cement, chalk, paper, glass and medicine. The demand for cement has increased due to the construction boom, which has exposed the inadequate capacity of the manufacturing plants in the country. The natural carbon which is a mineral is used in the carbonation of beverages. It is found in Kiambu County. Manganese is mostly used in the manufacture of steel and metallurgical products, including other chemical applications such as fuel additives or oxidizing agents.

This mineral was declared as scarce in 2007 by the International Manganese Institute. In Kenya, the huge deposits are yet to be tapped. Most of the deposits are found in Ganze and Mrima Hills in the Coast region.

Gypsum is found in Tana River, Garissa, Kajiado and Turkana. It is a mineral used in the production of plaster of Paris, fertilizers, cement, shampoos and hair products. It is also used to supplement calcium in food. Whereas, Diatomite which is found at the base of Rift Valley around Gilgil is used as an absorbent. Its

other uses include the manufacture of soap , detergents , bricks and pencils. It is also used in the purification of liquid substances such as grease, beer, and wine.

The vermiculite mineral is famous for its expansion properties. When heated, it expands up to 30 times its original size, thereafter turning colourless and becoming fireproof, making it a most useful material for insulation. In its original form, it is used in the manufacture of brake pads as well as in other industrial applications. It is found in large quantities in the Tsavo National park. However, gemstones which include: sapphires, tanzanite and other precious gems are found in varying quantities, but still significant quantities in Tana river, Taita Taveta, Kitui, Kajiado, Mwingi, Isiolo and Turkana. The exploitation of these minerals is still highly secretive. The latest mineral discoveries are those of titanium, oil and gas.

Titanium which is owned by a Canadian company is widely used as a base compound in aircrafts, space ships and missiles whose parts are built with titanium alloys for corrosion resistance and due to its tensile strength at low weight, and is used as rust proof which make it useful in surgical equipments, body piercings, as well as dental equipments, hip joints, ball joints, and other human body internal bone interventions which need no replacement for 20 years. In addition, it is also used in the manufacture of cement, toothpaste, paper and plastics. Significant deposits of these mineral are found in Kwale, Malindi, Lamu and Kilifi. The oil discoveries in Turkana county and the gas find in Lamu is likely to change the mining picture in Kenya in a fundamental way as will be discussed in this paper. It is evident that the country could be sitting on immense deposits of oil and gas. A detailed picture of mineral potential giving giving specific areas where some of these minerals are found within the country can be gleaned from a book published in 1975: 'M*inerals In African Underdevelopment: A study in the Continuing Exploitation of African Resources'* (Ochola, 1975).

The three main categories of mineral deposits in Kenya is captured in Box 6.1 which indicates that the first group of precious metals, gemstones, and semi-

precious stones which consists of gemstone, gold, rubbies, silver semi-precious stones and pumice. The second group of metallic minerals comprise of lead, zircon, iron ore and titanium. The third group of industrial minerals is made up of: soda ash, fluorspar, diatomite, salt, gypsum, mica, kaolin, and meerschaum. For example, mineral potential include: beryl in West Pokot, chrome and nickel mixture at Sekorr Mountain; copper anomalies in West Pokot and Macaldar, Migori; diamond indications in north of Kitale; diatomite in the Rift valley, Lake Elementaita; gold int Ndori and in the Migori belt. Graphite deposits at Bukura west, which were estimated at 17 million metric tons of 60 % ferrous content, plus large deposits which were discovered near Marimante. Manganese deposits occurrences at Mrima Hill, meerschaum in the Amboseli Basin, mica occurrences in West Pokot and Tsavo Valley; and deposits of rare earth oxides at Mrima Hills which are used in the manufacturing of televisions, metals, wind turbine and guided missiles. Wollastonite in Kajiado, while deposits of bastuaesite and wollastonite are known to exist especially in the south of Ruri Hills' Homabay.

Box 6.1: Main Categories of Mineral deposits in Kenya

Category	Minerals
Precious metals, gemstones and semi precious stones.	Gemstones, gold, rubies, silver, semi precious stones and pumice.
Metallic minerals	Lead, zircon, iron, titanium
Industrial minerals	Soda ash, fluorspar, diatomite, salt, gypsum, mica, kaolin, meerschaum

Source: Minerals and Africa's development, ECA, Addis Ababa, (2011)

There are also indications of kaolin and kyonite at Murka Hills ; silver and lead deposits in the Kinagoni Hills; barite whose production is limited and beryl from Embu area; gypsum production from Garissa and Malindi including niobium deposits and pyrites at Bukura with reserves put at 17 million metric tonnes containing 40% sulphur and between 41% to 62% iron ore, and pyrochlore

deposits in Mrima Hills. Some of the minerals that are being produced in the country are given in Table 6.40 below.

Most of the minerals produced in the country are exported in their raw forms without undergoing value addition at the country level. This leads to huge losses in terms of employment creation which would have been generated had the processing and manufacturing of these minerals taken place at the local level. Furthermore, the value-addition activities are also lost to the economy in terms of the multiplier effects, and the huge losses suffered as a result of having manufacturing of products undertaken outside the country as the export of raw materials fetch peanuts in the international market.

For example, some common uses of minerals in the manufacturing of other products indicate what value the economy forgoes by not undertaking value addition of these minerals locally. This information is captured in Box 6.2 on some of the common uses of minerals produced or to be produced in Kenya.

Even though Kenya is beginning to absorb minerals as it moves from a subsistence economy to an industrial one, its consumption of engineering products, including iron and steel is expected to increase. However, by and large, Kenya as other African countries still relies on the principles of exports to re-import. In a study undertaken by Ochola (1975), value added on processed in the case of Ghana was found to be 143 times that of the raw material commodity. This underscores the urgent need for African countries to process their raw materials before exporting them.

Table 6.40: Mineral Production (mt) and Sales Values (million Ksh) (2007-2011)

		2007		2008		2009		2010		2011	
		Quantity	Value of Sales	Quantity	Value of Sales	Quantity	Value of Sales	Quantity	Value of Sales	Quantity	Value of Sales
Soda Ash	Tonnes	386578	4769.5	502846	8881.7	404904	6085.4	473689	6980	499052	7354
Salt (Crude and Refined)	Tonnes	11596	58.1	24345	139.2	24125	154.7	6194	35.3	24639	140.3
Flourspar	Tonnes	85115	995.9	130100	1949.2	5500	122.5	40750	789	95051	3984.4
Soda Crushed Raw	Tonnes	843043	430.4	865788	442	948076	484	959160	467	1054236	495.5
Corondum (ruby)	Kgs	4800	47	4950	47.5	5575	57.5	5450	55.7	6240	66.5
Carbon dioxide	Tonnes	11028	78.6	22030	117.9	15711	84	16345	98	16275	105
Diatomite	Tonnes	201	8.9	72	3.5	231	14	224	9	713	15
Garnets (green)	Kgs	815	26.4	821	27.2	965	29.3	1075	30.5	1205	35.5
Gypsum**	Tonnes	5000	5	5,000	5.2	5345	5.3	5500	5.4	6520	6
Vermiculite	Tonnes	300	78	320	78.5	315	79	395	83	515	88.5
Gold (Unwrought)	Kgs	3023	3922.9	340	592.9	1055	2284	2355	6217	1636	5651
Gemstones	Tonnes	9	111	21	178.6	39	141.3	168	226	310	231
Total			12538.7		14471.4		11550		14995.9		18172.7

Source: Mines and Geology Department, Kenya Provisional

**Excluding Gypsum used for Cement.

Box 6.2: Common uses of some of the minerals produced and to be produced in Kenya

Minerals	Common uses of minerals products
Barites	Fertilizers, disinfectants, detergent, water softener, corrosive inhibitor, pneoomaceuticals, food preservatives
Coal	Electricity generation, steel making, chemical manufacture, production of liquid fuels, plastics and polymer
Copper	Building , construction (wire , cable, plumbing and gas tubing, roofing and climate control system) aircraft parts, automotive parts (wire, starter motor, bearings, gears, value, grades), industrial application and machinery (tools, gears , bearings, turbic blades), crafts, jewelers, artwork, musical materials, cook ware
Feldspar	Steel making, aluminum, fluoroocarbon, (used refrigerants, blowing agents solvents, aerosols, sterilants, fire extinguishers) manufacture of lenses for microscopes and telescopes, fluorescent bulbs, glass, ceramics, enamel, tile, glares, paint, welding, electrodes, plastics etc
Iron ore	Steel making, alloy
Kaolin	Filter for paper, rubber, plastic , paint and adhesives, ceramics, fiberglass, cement, catalyst for petroleum, refining, dispenser, pharmaceutical and cookery
Gypsum	Building construction (plastic board, plasters and camout) agriculture, glass, chemicals , shampoos
Lead	Batteries, cable sheathing, solder and radiation protection, anti-knock compound in petrol, plumbing, ammunition
Limestones	Cement, fertilizer, chalk, paper, glats, iron influx, paints, plastics, livestock feed, soil condiores.
Manganese	Steeling making, alloys, batteries, colourants and pigments, welding fluxes, agriculture, water treatment, hydrometallurgy, fuel addictives, oxidizing agents, odour control, catalysts, metal coating
Nobum	Alloys, stainless steel, advanced engineering systems (space

	programmes), nuclear industry, electrical products, jewellery
Titanium	Production of light weight alloys, aircraft components (jet engines, aircraft frames) automotive components, joint replacement (hip ball and sockets), paints, watches, chemical processing equipment, pulp and paper processing equipments, pipes , jewellery, dental equipment, rust proof equipment.
Soda ash	Glass, detergent, chemicals, water treatment, flue gas, desulpurization, pulp and paper, salt, preservatives, dyes.

We need not overstate the greatest social and economic benefits that would accrue to the present and future generation of Kenya if the government could undertake to develop the capabilities and

Capacities required for value-addition and diversification in the utilization of its mineral wealth and other natural resources in the interest of economic development of the country. In our view, this would constitute the most prudent way of achieving a sustainable economic growth and development.

6.1.1. The Demand for Mineral Resources

Africa's mineral resources have never been in higher demand with phenomenal price increases over the past decades; driven by urbanization and industrialization of major economies. First led by the US economic growth, second by post war reconstruction in Europe and Japan, and third which is now driven by China's materials led growth (UNECA, 2011). The six base metals that are traded on the London Metal Exchange (LME)- aluminium, copper, lead, nickel, tin and zinc are key inputs in construction, transportation and heavy manufacturing.

Given high demand for mineral resources, it is no surprise there should be considerable investor appetite in establishing investments in the mining sector in Africa. The strategies that mining firms are using, given this trend include consolidation through mergers and acquisition (M &A). This also involves diversification, and upstream vertical integration of operations in which mineral

trading companies own substantial stakes in ore producers. Indeed, the ownership of mining operations in Africa and trends in investment even as seen in Kenya have changed since the 1990's after African countries liberalized their economies due to the Structural Adjustment Programmes which severely curtailed infrastructural investment and unbundled state owned mining enterprises in a bid to attract foreign investment in African countries.

The new participation in mining M&A interest in Africa by large foreign companies, for example, increased Chinese acquisition of Australian mining companies by converting them into major force in Africa's mining sector. China's aggressive engagement of African Countries has turned the poles of influence in development assistance and trade away from Western countries. What has come to pass is the large infrastructure projects offered by China in exchange for mineral resources invariably raise questions of policy implications for development planning in Africa. While this strategy may be new, but its underlying principles remain intact, namely that of securing long term supply of strategic Africa's resources including minerals and oil.

As can be seen, China almost exclusively rely on Sub-Saharan Africa for its cobalt imports, manganese, chromium and the region is a growing source to China's imports of iron ore and copper. But, the two distinguishing factors associated with Chinese investment in the mining sector are the establishment of mineral processing operations as well as infrastructure that facilitates the mining and transportation of products to the ports. These investments are usually accompanied with the price tag of favourable mineral concessions. What is equally clear is that African countries old form of dependence on natural resources has not changed as countries such as United States of America still facilitate activities that sustain its mineral supplies including exploration, development, technology, recycling and appropriate environmental protection, if this is ever carried out. The European Union, on the other hand, has a Joint Strategy and Action Plan to reinforce its dialogue and actions in access to raw material and natural resources management including transport infrastructure. It

is within this framework, that African countries trade with the outside world still follow the same old path of unequal exchange as demonstrated by the difference between export volume and the value-added that goes into the exports. This is not only a matter of primary commodity export dependence, but also the nature of manufacturing output in the global division of labour. Indeed, the mineral price boom should not disguise the unequal and unfair system of export-led growth. Even the World Bank which is the strongest supporter of export of primary products, was forced to submit in its report—Where is the Wealth of Nations, (2005) that some African countries are vast losers via export processing, and that Africa is much poorer not wealthier than it would have been without the emphasis on the export of primary products. While trade liberalization damage is not limited to the primary export drive alone, but the African elites excessive rapid lifting of the protective tariffs led to the premature death of instant industries and manufacturing jobs, and decline in state customs revenue. As a result, "trade liberalization has cost sub-Saharan Africa US$ 272 billion over the past 20 years" Christian Aid (2005).

While overall natural resource accounted for nearly 80 percent of Africa,s export in 2000, and that most countries depend upon a single commodity for export, the main problems associated with primary product export dependence are not only high levels of price fluctuations for many natural resources, but the highly capital-intensive nature of its production especially for minerals, which end in providing greater dangers of intervention by parasitical rentier states (Cornia, 1999). Furthermore, the crucial question to ask is whether the same strategies that enabled industrialization in the past can be applied to African countries that remain caught in the commodity trap, especially with respect to mineral exports, where depletion of non-renewable resources drains the wealth of future generations. It is also within this context that the export and import of natural resources will be examined.

6.1.2. Export and Import of Natural Resources

Theoretically, trade contacts between independent buyers and sellers are based on the principle of supply and demand. But the kind of trade contacts in the field of mineral resources are of three types:

(i) First is the direct participation by steel-makers or other mineral manufacturers in the working of mines overseas. This is the normal practice established among, for example, among steel producers or other manufacturers in order to secure the long- term supply of strategic resources and to control the price increases over long period of time.

(ii) Second is where mineral manufacturers use or sign long- term contracts – China or Japan usually sign contracts on long –term bases, sometimes for a duration of more than twenty years, as a guarantee of a constant source of supply.

(iii) Third, is the free market system. However, the use of this market accounts for hardly one third of world imports of iron ore for example. By acquiring controlling interests in overseas mines, the steel makers aim at obtaining ore at lower net costs and at the same time insulating their supplies against price fluctuations. This kind of practice is true for other minerals and hydrocarbons as well.

In other words, the mineral outputs are sold in captive markets. The companies which own mines do sell extra quantities of mineral raw materials on the free market relatively cheaply because their major objective is not to make profit on the actual sales but to drive down the unit cost of the raw materials that are to be delivered to their manufacturing industries. Since producing countries do not own the mines, they have no control over the prices which their raw materials should fetch.

According to UNCTAD (2003), the overall primary exports of natural resources accounted for nearly 80% of African exports in 2002, compared to 31% for all developing countries, and 16% for advanced capitalist economies. In 2003 a dozen African countries were dependent upon a single commodity for exports, including crude petroleum (Angola 92%, Congo 57%, Gabon 70%, Nigeria 96%, Equatorial Guinea 91%); Copper (Zambia 52%); Diamond (Botswana 91%); Coffee (Burundi 76%), (Ethiopia 62%), (Uganda 83%); Tobacco (Malawi 59%); and Uranium (Niger 59%).

The individual African countries high dependence on a single commodity for export conforms to the Rybczynski theorem of standard trade theory which predicts that international trade will reinforce a nation's specialization in the factor—either capital or labour—that is used most intensively in its exports. In *other words, when only capital grows, the output of the capital-intensive commodity expands and the output of the labour- intensive commodity contracts (Mithades 1978) and perhaps vice versa.* The terms of trade which refers to the relationship between the price of a country's export commodities and the price of import commodities also indicates that a country's terms of trade in favour of its exports increases its economic welfare. If the price of a country's exports increases relative to its imports, the country gets richer. This kind of trade tends to favour large countries that have market power to threaten smaller countries. But in the opposite effect, the country gets poorer, since trade is less likely to expand their consumption sets.

6.1.3. Kenya Exports to Imports

Most of the mineral resources that the African countries export in the form of raw materials, they import in the form of semi-finished or finished goods. For example, Kenya imports motor-cars, copper wires, building materials such as steel, aeroplanes, television sets and so on. These finished products come back with a high value added for which the country pays quite dearly while the country has all the basic elements for the manufacture of steel such as high quality iron ore deposits in Kwale, rich coal deposits in Kitui, manganese deposits

and other mineral resources, deposits in the country which provide inputs for steel manufacturing, the discussion on the use of these resources still revolve around exportation and not manufacturing. The problem is that Kenya policy-makers are unable to think outside the dungeon of raw material exports. A simple tabulation shows three categories of some of the mineral raw materials namely aluminium, copper ore, and lead ore and unwrought that are exported by some African countries and then re-imported in semi-manufactured form by either the same countries including Kenya.

The value-added on processed aluminium was found to be 143 times that of the raw commodity. Even in the case of China that manufacture copper cathodes in the Chinese operated SEZ in Zambia and then export to China will not move the country out of the raw material trap, but would leave it ensnared in a mercantilist cycle in which it will keep selling raw materials in exchange for Chinese manufacture (Kurlantz C. K., 2007). Therefore the only way open for African countries is to increase the value-added by processing the raw materials locally before exporting them. Furthermore, what Table 2 shows clearly is the need to boost intra-African trade. There appears to be little sense in exporting primary commodities to developed countries and then the developed countries exporting the same product in final manufactured form to both the original exporter and other African countries. The promotion of intra-African trade would result in the development of infrastructures of a new kind. It would link, at least physically, the African countries to themselves rather than only to the developed countries. It need hardly be emphasized that infrastructural development will constitute towards economic growth by facilitating Africa's participation in global and regional markets through reduced production and transportation costs, as infrastructure development reduces poverty and promotes trade at the same time.

6.2. Theoretical Framework and Curse Hypothesis

The standard economic theory suggests that high prices for oil and other natural resources should benefit producer countries in two ways:

First, is that the large inflows of export revenue should create investment opportunities in projects and programmes that promote development on the assumption that full information, and comprehensive knowledge on how development and investment opportunities can be fully exploited. It is also important that institutional as well as human capacity to implement and act upon decisions taken is readily available.

The second assumption is that the inflows of foreign-exchange arising from natural resource exports would be used to generate domestic saving rates that would facilitate the importation of capital goods necessary for economic development. However, improving domestic saving rates alone may not necessarily promote development, especially when savings remain in local currency.

Only with a few exceptions, has the potential benefits of oil and other natural resource revenues been properly utilised in a manner that would generally generate wealth to the society. The exporting countries have thus failed to harness natural resource revenue in a manner that would transform the developing countries into emerging market economies. It is this poor outcome which has been called the 'resource curse'. The debate on this topic has consequently developed a huge following among economists and formed a grand theory on all natural resources (Sachs and Warner, 2001). For them, the curse become an impediment to economic development by causing the Dutch disease, namely: the slump in other sectors of the economy that accompanies the influx of revenues from natural resource exports (Lahiri Dutt, 2006). In this context, the existence of mineral or oil deposits is therefore no guarantee to economic development, and it is also within the same context that, whether deposits turn out to be a blessing or a curse, will largely depend on governance—namely the quality of their institutions, their capacity to properly manage these resources, and to use them to catalyse development.

Indeed, the dependence on natural resource revenues makes the national economy vulnerable to resource price volatility and, as governments borrow excessive amounts in the hope of making repayments from natural resource earnings,   the fall in real exchange rate or prices combines to destabilize the economy and makes the debt burden impossible to repay. The other associated factors that help to spread the curse leading to a 'failed state' are corruption, low income and education levels of the people.   Such theorizing involves diagnostic prescriptions on how to manage natural resources in order to escape the resource curse.

Attempts have been made   by political scientists to escape this economic determinism by emphasizing that resource curse theory needs to take into account the close relationship between economic factors and political institutions, since economic and political outcomes of natural resource abundance are likely to differ between countries (Mehlum et al, 2005). For the political scientists the quality of institutions determines whether or not resource rents are channelled into the productive economy by creating either democratic states or rentier regimes. In a rentier state, the revenue generated by natural resource exploitation allows the incumbent government to frustrate democratisation   by keeping down taxes on other economic activities and by undertaking unproductive redistributive spending to satisfy political constituencies.   In this regard, natural resource wealth tends to consolidate and conserve bad political regimes, which undermine social and cultural processes that would facilitate democratic changes.

 Basedau (2005) has on the other hand underscores the local context of understanding why resources may act as a curse or a blessing.

While there has been no clear understanding or agreements on the sources of resource curse or blessing. Watts (2004) has put blame on 'commodity determinism' theory which pays inadequate attention to the specific nature of the resource. Others have simply equated export of mineral products with resource

abundance (Wright and Czelusta, 2003).These theories give the impression that only large scale mining by the international companies as the only legitimate form of mineral resource exploitation and that the local people have no place since mining operations are capital-intensive in nature. A factor which has frustrated the building of capacity at the local level for carrying out mining activities.

In the late 1970s, some researchers noted that economic performance of several developing countries with abundance of mineral and energy endowments measured as percentage of the real GDP, and that depend on the export of these resources have always performed below expectations. Naikani(1979) and Gelb (1985) who considered this situation in oil-rich economies found mixed outcomes. Gelb et al (1988) posited that the existence of a "resource curse" in oil rich developing countries was, the cause for poor outcomes. However Auty (1995) also argued that resource curse applied in the case of 'hard-rock' developing economies as well. In an econometric study on the economic growth experience of 97 countries carried out between 1970 and 1989, Sachs and Warner (1995), found that natural resource abundance was negatively correlated with economic growth. But Auty (1993, p.1) further argued that the essence of the resource curse is that:

> "the economic performance of nations with a significant mineral (or other natural resource) endowment may be worse than those without such endowment".

Atkinson and Hamilton (2003, p.793) on the other hand perceived resource curse as:

> "The paradoxical but seemingly robust finding of a negative and significant relationship between natural resource (abundance) and the growth rate of per capita gross domestic products (GDP)".

Furthermore, they also found that: saving rates were on average lower in resource abundant countries than in resource-poor countries. While in their later study Sachs and Warner (2001, p.827) stated that "countries rich in natural resources tend to perform badly", Auty (2001 a) on the other hand noted that the per capita incomes of resource-poor countries grew at rates of two to three times higher than those of resource abundant countries between 1960 and 1990. Neumayer (2004) also confirmed the negative impact of natural resources abundance on economic growth measured in terms of 'genuine income', that is, GDP minus the depreciation of produced product and natural capital, rather than GDP.

The mineral rich economies are said to have performed poorly in terms of agricultural growth, export diversification, and inflationary pressures as compared to non-mineral producing countries, whose economies were characterized by good savings performance, greater technological development, low unemployment, lower indebtedness and robust export earnings resulting from greater economic diversification arising from investments in the productive activities. Wood and Berge (1997) on the other hand found that resource abundant countries were less likely to export manufactured products than the resource poor countries, because as argued Leite and Weidmann (1999), natural resource abundance tended to worsen corruption since the growth of the oil and gas sectors is associated with the concentration of bureaucratic power in the hands of a small number of people, making it difficult to achieve transparency which prevents government officials from agreeing with terms that the citizenry cannot politically accept, and to implement pro-growth and development strategies that favour industrialization. Ross (2003 a) also confirmed that both oil and non-fuel minerals wealth tended to worsen poverty and lower the levels of human development exactly for the same reason.

We, however, argue that natural resource deposits need not be a 'curse', but should be a blessing for the development of the citizens and communities where these resources are found, on condition that they would have equal share in their utilization and also have a say on how these resources should be used. But due to the paucity of human capacity and capabilities at all levels of development of the African countries; it has not been possible for these countries to graduate from operating as warehouses of raw materials, and to walk out of the 'dungeon of raw material export'. This state of affairs ends in opening wide Africa's door for plunder and free loot of its resources. This too has opened the doors for the intellectual justification of why a 'veritable storehouse of mineral wealth should be defined in terms of development 'paradoxes' of 'curse' or 'blessing', when nature's gift should only be considered as a blessing.

6.3. Literature Review

The curse of natural resources is a well documented phenomenon for developing countries.

But prior to the late 1980s, the prevailing view was that abundance of natural resource was advantageous for economic development. This view contradicted the classical theory which predicted that abundance of natural resources should be good for the economy. In the 1950s and the 1960s similar views had been expressed by Jacob Viner (1952), Arthur Lewis (1956), and Walter Rostow (1961). In the 1970s and 1980s economists like Bela Balassa (1980), Anne Krueger (1980) and P.J. Drake (1972), put forward the same arguments that natural resources could facilitate a country's industrial development by providing investible funds to the domestic markets. However, these views had been challenged during the 1950s by Singer, Prebisch and others who argued that the structure of the global economy and the nature of the international markets were such that reliance on natural resource exports would be detrimental to developing countries. But this was however a minority view.

In the late 1980s, the World Bank and IMF challenged the theory that natural resources is a blessing. The World Bank and the IMF views were so influential that the idea of natural resources being bad for development was widely accepted (Davis et al, 2003; Isham et al, 2002; Oxfam, 2002). However, a few dissenting views were expressed. Kuntala Lahiri-Dutt(2006) pointed out that some of these arguments had hidden meanings. She stated that they were meant to pre-empt any possible alternative explanations of how the communities in the Third World countries could make use of their mineral resources in a beneficial manner. It is therefore reasonable to ask why nature's gift should simultaneously be both a curse and a blessing. The literature review therefore seeks to shed light on some of these arguments.

The World Trade Report (WTR) 2010: Trade in Natural Resources, while acknowledging the difficulty in defining natural resources in the context of international trade, the Report defines it as: "stocks of material that exist in the natural environment, that are both scarce and economically useful in production or consumption, either in their raw form or after a minimal amount of processing" (WTR, 2010 P. 46). Indeed, 'natural resources' has also been defined in terms of particular commodities e.g. oil, minerals, forest resources and agricultural crops. Some scholars have defined it in terms of the abundance of land or the size of the primary sector. The various definitions notwithstanding, this paper opts for Andrew Rosser's view that examined natural resources in terms of their developmental effects (Rosser, 2006), by distinguishing studies that examine the developmental effects of natural resources in general and those that examine the developmental effects of particular resources, such as oil, gas or minerals as 'point source' resource and 'diffuse' natural resources such as coffee and tea.

The review provides reasons for the curse that make mineral and oil resources to be labelled as a 'curse'. Raymond Mikesell (1997) had argued that there is no single dominant explanation for the resource curse. In Africa, including countries in transition, the experience is that in the 1980s and 1990s the Structural Adjustment Programme weakened the state and worsened the proper

management of the exploitation of the continents natural resources. Tobia Kronenberg (2004) has also provided possible explanations for the resource curse to include: rent-seeking and corruptive behaviour; crowding out of manufacturing (the Dutch disease); neglect of investment in human capital; and the non-sustainability of resource extraction, and others such as political instability and civil wars instigation. These are some of the key factors that render the abundance of natural resources not to be a blessing.

6.3.1. Threats to Democracy

Post independence states often adopted th authoritarian tactics and institutions of their colonizers in order to consolidate their political and facilitate the extraction of resources from the rest of the society (Reno 1995).The finding presented by Jensen and Wantchekon (2004) in relation to the African countries reconfirmed that whereas the resource abundance countries were likely to be authoritarian, the role that social forces play in shaping these development outcomes should also be taken into account. Interestingly, Wantchekon (1999) who examined data of 141 countries between 1950 and 1990 found that a one per cent increase in natural resource dependence, measured by the ratio of primary exports to GDP increased the probability of creating authoritarian government by nearly 8 per cent. He further found that countries that were rich in natural resources were more likely to be failed states and experience slow transition to democracy. Tobias Kroneberg (2004), on the other hand, observed that since natural resources are often found in areas that are not easily accessible and are thinly populated, the application of the rule of law in such areas becomes difficult.

Auty and Gelb, (2001) emphasized that countries with resource abundance had a tendency to become predatory or functional states and were likely to become victims of the resource curse. Ross (2001a) who examined data from 113 countries between 1971 and 1997 concluded that states' reliance on oil or mineral exports tends to make them less democratic irrespective of their sizes, whether big or small. It is in this respect that scholars have suggested that

institutions become more important determinants in the resource driven outcomes than the resource endowment per se,(Acemoglu et al 2001).

In the African context, where different types of colonization created different sets of institutions in the resource-rich countries, the post-colonial governments not only adopted the authoritarian form of rule of their former masters, but also their institutions. This not only enabled the new African leaders to create extractive economic and political institutions (Acemoglu et al 2013) but also to consolidate their political power and facilitate the extraction of resources from the rest of society (Reno, 1995).

In such a situation a state as an extractive institution will not be pivotal in safeguarding the gains that are to be made and to be captured by a few elites who extract the resources from the rest of the society and block economic development. This will spell doom as they seek to strategically influence the design of policies, laws and contracts to their advantage at the expense of the interest of the wider society (The East African, October,19th._to 25th.,2013 p.36).

6.3.2. Political Instability and Civil Wars

In the new independent mineral-rich countries that comprise disparate ethnic and cultural populations, where institutional structures are poorly formed, and human capital development levels are low, there seems to be an irresistible tendency towards political instability that sometimes leads to civil wars. A number of studies on civil war have suggested links between natural resources abundance, civil war and political regime types, and demonstrated a strong correlation between 'developing states' reliance on natural resources and the likelihood of conflicts (Collier and Hoeffler, 2001). In this respect, Ross (2001) identified 14 civil wars that have taken place in resource-rich countries over the past 35 years. Out of the14 civil wars, nine (9) were in Africa : Angola, Nigeria, the Democratic Republic of Congo,(Zaire), Liberia and Sierra Leone;, two (2) were in Indonesia, two (2) in Middle East; and one in Oceania.

While the ad-hoc nature of the geographical boundaries as drawn by the colonial powers may also be a cause of instability, but the combination of the desperate structures and institutions has played a major role in creating ethnic tensions, conflicts, and political strives. However, the sharing of benefits from the exploitation of these resources plays an important role. Collier and Hoeffler (1998), in examining the experience of 98 countries and 27 civil wars found that natural resources abundance, defined as the ratio of primary exports to GDP to be a significant determinant on the onset of civil wars. They also found that the relationship between natural resources variables which was initially curvilinear, increased the risks of civil war, but after a certain level of exports had been achieved, the risk was gradually reduced. Therefore, natural resource abundance is a key variable in explaining the incidence of non-ethnic civil wars and other types of political violence.

A similar study conducted by Reynal-Quarol (2002) also confirmed natural resource abundance to be a key variable in explaining the incidence of non-ethnic civil wars and other types of political violence, but not an important factor in explaining the incidence of ethnic civil wars, as confirmed by the data taken from a sample of 138 countries between 1960 and 1995. However, indicated that it was not important in explaining the incidence of ethnic civil wars. Collier and Hoeffer (2005) further pointed out that natural resource wealth continued to exhibit a curvilinear relationship with the onset of civil war even if rent based measures on natural resource abundance were substituted with their original export-based measures.

With regards to the duration of the civil wars Fearon (2004) suggested that countries with contraband resources, such as drugs including diamonds, tend to experience longer civil wars. Ross (2003) also demonstrated that if all the major types of natural resources, diamonds and illegal drugs were strongly associated with the civil wars that took place between 1990 and 2000, he noted that the "loot-ability" of a resource, whether it has a high value-to-weight ratio or not, so long as it can be easily appropriated and transported by unskilled workers, has

the potential to cause war. But in non-conflict situations, he also observed that lootable resources generally produced more widespread benefits to local the communities and the poor than non-lootable commodities. Given the potentially destabilizing effect of the uncontrolled exploitation of diamonds in Sierra Leone, for example, what is needed is public participation in resource management decision –making processes as institutions at all levels are forced to address issues such as democratization, accountability and transparency (Ribot 2004). This is important because despite the various initiatives and guidelines to restore the diamond industry in the country in support of economic reconstruction, it seems that for many TRUCs and other actors, it is 'business as usual' (Maconachie and Binns, 2007).

6.3.3. Economic Growth or Poor Outcome

A number of studies that have documented the resource curse have also found a significant negative correlation between natural resource abundance and economic growth. This is a puzzle, as it contradicts the classical economic theory which predicts that the abundance of natural resources should be good for the economy. The economic theory in the 19th and early 20th centuries regarded land as a natural resource and an important factor of production.. The Malthusian argument that since land was a limited resource that does not grow, all other production factors would eventually run into diminishing returns and thus economic growth would stop.

The production and exportation of goods with diminishing returns, namely the raw materials has not only had a devastating effect on their economies, but has also locked them up in the prison of producing and exporting goods with diminishing returns and not increasing returns: namely the manufactured goods, that have undergone value addition and which will not be subjected to wild international price fluctuations, and which will enable African countries to exchange industrial goods with other industrial goods, and not raw materials. This is what UNCTAD refers to as symmetrical trade that benefit the poor and not asymmetrical trade that does not. It is therefore imperative that the countries

should move into symmetrical trade which is good for economic growth. This should also be the case with mineral exports.

The African countries have as a result of asymmetrical trade been pushed into a permanent state of "de-industrialization". It is in this respect that classical economists' arguments would not hold, unless a country with more natural resources than another similar country stopped producing goods with diminishing returns and move into the production of goods with increasing returns. The former would enjoy higher output per worker and higher living standards. If all countries in the world are engaged in symmetrical trade, then this would translate into higher growth rates even for countries with abundant natural resources.

6.3.4. The Creation of Predatory or Rentier States

Furthermore, a state-cantered perspective suggests that natural resource abundance leads to poor economic performance not by influencing the behaviour of the political elites or social actors, but by influencing the states capacity to promote economic development. Furthermore, a resource rich country's revenue does not depend on the strength and success of the overall economy, the government of the resource-rich country does not see the need to be involved in activities that support the economy,   as a result the government can invest its earnings in oppressive capacities. Indeed, less reliance on tax revenues is thought to hinder the development of effective states in many resource rich developing countries (Moore, 1998). Most scholars have identified problems associated with what is called 'rentier' states, namely states that receive regular and substantial amounts of 'unearned' income in the form of taxes on natural resources exports, or royalties on natural resource production (Tanter, 1990; Vandewalle, 1998; Gunn, 1993; Chaudhry, 1994). But since these states have large amounts of unearned income to spend, it has been argued that they tend to develop greater capacity to distribute earnings from the mining activities to programmes such as social welfare, education, health and productive functions. Karl (1997: 16) on the other hand argued that dependence

on oil revenue leads to the emergence of petro-states or what is generally labelled as predatory states that are only interested in the political distribution of rents and not in the promotion of investments in production and economic growth. The domination of oil gives the state a distributive character which in the context of the stickiness of institution becomes locked in. In the developing countries that ride high on corruption, the state's financial autonomy literally means little or no accountability to the citizens, increasing the likelihood of developing predatory and factional oligarchic states rather than developmental state, for four main following reasons:

The relative abundance of land and the existence of natural resource rents creates a high tolerance levels for the poor majority to put up with inequitable asset distribution and predatory rent extraction, which reduces the chances of the state to promote equitable distribution of asset;

The resource abundance countries tend to adopt protective trade policies rather than developmental export-oriented policies which are affected by the Dutch disease;

The large size of the resource sector implies that it can support inefficient inward-looking industrial sector supported by the transfers from the resource sector; and

 Resource abundant countries are more prone to cumulative policy error (Auty and Gelb, 2001 128-129).

Since corruption remains the hallmark of predatory states, it may take many forms as they seek to maximise their loot. The states may collude with international mining companies to obtain resources below market value by bribing government officials than by working out how extract resources more efficiently. Sometimes, government officials may get kickbacks in exchange of ownership sharing. The cost of such corruption to the national economy is

normally enormous, and results in destroying the economic development of the country.

6.3.5. Rent Seeking and Corruptive Behaviour

The availability of natural resources therefore tends to lead to massive rent-seeking and corruption in the government. Corruption always goes hand in hand with rents seeking, because the pressure groups tend to block political reforms in order to protect their harvests from rents. This behaviour is found to be more common in countries where natural resources are abundant since the extractions of these resources are usually controlled by the big transitional corporations or state authorities. Bardhan (1997) has on the other hand argued that corruption has its adverse effects not only on static efficiency situation, but also on investment and economic growth. Therefore, natural resource abundance by concentrating wealth and power in the hands of a small group of the elites does foster corruption and rent-seeking behaviour, which in turn depresses economic growth as incentive to invest is reduced, while the remaining investment is not used efficiently.

The entry of the political scientists into the debate introduced new analytical framework such as behaviorialism, public choice theory, Marxism, institutionalism, statism, dependency, world system theories, and fiscal sociology all of which called attention to the role of political factors in shaping the economic outcomes and not resource curse as is popularly advanced. The behaviouralist perspective suggests that natural resource abundance leads to various types of emotional or irrational behaviour on the part of political elites ending in poor economic policy- making and institutional deterioration (Rosser, 2006).

Such arguments featured in works of great political and economic theorists such as Machiavelli and in the work of economists such as Wallich (1960) and Watkins (1963). More recently, such arguments have also featured in the works of Mitra (1994) and political scientists such as Krause (1995) and Ross (1999).

Indeed, resource curse has appeared in the popular media where in certain instances, it has been likened to a drug.

The rational actor perspective on the other hand portrays political actors as rational-utility-maximizing individuals. Accordingly, they have argued that the proper analysis would be to accept the fact that natural resource abundance does lead to irrational behaviour on the part of the political elites, and that it provides them with an opportunity to line their own pockets by engaging in rent-seeking activities and outright embezzlement of public resources for private gain. Trovik (2002), asserts that natural resource abundance increases the reward that social actors are likely to harvest from rent seeking and in turn, gives them greater incentives to embrace such behaviours. The economic outcomes are therefore likely to be negative as political elites seek to redistribute economic resources in a manner that only benefits them. As observed by (Robinson et al 2002) that is not a resource curse arising out of resource abundance but outright plunder.

6.3.6.   The Dutch Disease

Resource abundant countries tend to become susceptible to the so called the Dutch disease. The Dutch disease hypothesis indicates that a sudden rise in the value of natural resource exports results in appreciation of the real exchange rate, which end in raising the price of non-tradable goods and wages and destroying the manufacturing sector activities including other non-tradable sectors (Bruno and Sachs,1982), which make the use of labour and some non-tradables as inputs, to be less competitive internationally. This reduces the overall economic growth. It is for this reason that Sachs and Warner (2001) have argued that the abundance of natural resources curse lies in the fact that natural resources tend to crowd out the manufacturing activities which are of crucial importance to economic growth. Bruno and Sachs further explained that crowding out of traded-manufacturing industries by a dominant natural resource sector can permanently depress economic growth, as the benefits from the natural resource tend to accrue to the wealthiest part of the society which have

little incentive to put their money into investment portfolios that yield high social returns. Instead, they tend to engage in unnecessary conspicuous consumption and 'Western' spending patterns that contribute little to social welfare. By contrast, the countries that are poor in natural resources tend to invest a larger share of their total export revenue in the manufacturing sector activities that stimulate greater competition and force the entrepreneurs to undertake more investment in new capital and technology. These results in increased labour productivity, growth output, rise in wages and higher returns on capital investment. As the virtuous circle in the manufacturing sector settles in, the whole economy grows. But the Dutch disease can also spell doom, when the activities in the natural resource sector eventually show.

6.3.7. Insufficient Investment in Human Capital

In a mining economy, overconsumption comes under investment. It has been found that dis-investment in human capital undermines economic growth in resource-rich countries when a government has a limited time horizon and when it fails to see the long-term benefits of education, as the immediate gains from the natural resource exports become more visible (Gylfason, 2001). As the countries begin to rely on natural resource wealth they also start to forget the need for a diversified and skilled workforce that can support other economic activities when the resource wealth dries up. But given the capital-intensive nature of natural resource extraction, the tendency is to lobby mineral producing countries into subsidizing capital accumulation at the expense of public spending on education, while the natural resource sector offers a few well-paid jobs, and limits its impact on education to the elite group, as the majority who are outside of this group find it difficult to get employment even if they posses adequate skills.

Under the circumstances, the young individuals may begin to feel that investing in education has very little impact on their prospects of finding work in the labour market. Schooling which is essential in the accumulation of knowledge, becomes consumption good rather than an investment good. In comparison to the social optimum, it will be inefficiently low (Birdsall et al, 2001). Gylfason (2001) has

further provided empirical evidence for the negative relationship between natural resources and growth via education channel. Using public expenditure in education as an indicator, Gylfason found a statistically significant relationship between natural resource abundance and low levels of education. However, he finds that as the share of national income spent on education declines, the secondary school enrolment and the years of schooling for girls also decreases. While the costs of such declines might not be felt in the short term because capital-intensive activities take up a large share of national production, but their negative effects will become significant in the long –run. He concludes that, about half of the natural resources curse is positively linked to education.

6.3.8.   Non Sustainability of Mineral Resource Extraction

While the use of renewable resources is unsustainable if they are depleted too quickly, the extraction of exhaustible natural resources is by definition non-sustainable in that, once uprooted, these finite resources cannot be returned to their original state (Moody, 2007).   Therefore, whatever the justifications for digging up more and more minerals, their stock is continually going down as the rate of their depletion has accelerated over the years. Furthermore, natural resource extraction per se cannot be reconciled with long-term sustainability, even though the industry spokes-persons would like to make us believe that there is such a thing as sustainable mining.

 The question to be answered then is whether mining can contribute to 'sustainable development' through job creation, the building of infrastructure, paying of taxes, and the funding of social services aimed at alleviating poverty and generating economic growth for sustaining a more prosperous future. The other critical question that needs to be asked, that relates to the issue of sustainability is the environmental degradation that accompanies natural resources extraction or the use of these resources. In Africa, particularly in the East Africa region, the discovery of oil and gas is already pointing to the destruction of the delicate ecological system, the rich fauna and flora, including

the very livelihoods of the local communities who are likely to bear disproportionately high environmental costs of oil or mineral extraction.

While strong evidence to support the resource curse theory exists, the debate is not however conclusive, as doubts about the findings of the various studies that are supportive of the resource curse hypothesis have been questioned. Further, it is not clear whether the resource curse applies to all natural resources, as some studies report findings that do not support the resource curse hypothesis. Finally, some of these studies do not conclusively illustrate that the direction of causation runs from natural resource wealth to poor development outcomes rather than the other way round. As a matter of fact, the relationship between the two does not reflect the influence of an independent third variable.

Indeed, some scholars have argued that a research agenda that differ from the econometric work that has supported the resource curse hypothesis might be needed since the quantitative work may not be suited to capture important aspects of economic and political challenges of natural resource rich countries (Stevens and Dietsche, 2007). Rosser (2006 b) puts forward an argument for case studies that search for the social and political conditions under which natural resource rich countries are able to escape the resource curse. This implies that it is not mineral or oil per se that cause the resource curse, but other combination of factors that make nature's gifts to be labelled as a curse and not a blessing.

In as much as uncovering correlations has been helpful, but they have also supported contradictory claims, and have raised more difficult questions than answers.

6.3.9. Overcoming the resource curse (2007)

In their seminal work 'Escaping the resource Curse' (Humphreys ,Sachs and Stiglitz (2007)) state that to overcome or escape from the natural resourse abundance paradox, there is need to understand two critical issues. First, is that natural resource wealth does not need to be produced, it is simply to be

extracted. Second, is that many of the natural resources are non-renewable. This is the first characteristic of what extraction means that unlike other sources of wealth the process of its production can take place independently without major linkages to other industrial sectors or without the participation of the larger segment of the domestic labour force, hence its "enclaveness". The second main feature stems from the fact that natural resources namely minerals, oil and gas are non-renewable. From an economic aspect, they are less like a source of income and more like an asset. These two features of being detached from domestic and political processes, and the non-renewability nature of these natural resources give rise to political and economic processes that end in producing adverse effects on an economy (op.cit, Humphreys et al). Further, these create rampant opportunities for rent-seeking by corporations in collusion with political class in order to exploit the natural resource wealth.

While several recommendations have been made in the various literatures on how to overcome the resource curse, the debate has focused on the need for economic policy changes as key in overcoming the resource curse in resource rich countries. The first policy measure that has been proposed is for the resource abundant countries to adopt sensible macro-economic policies; avoid large foreign and domestic debt; accumulate budget surpluses; control inflation and pursue competitive exchange rates (Usui, 1997; Mikesell, 1997). These measures would also assist resource abundance countries to avoid the Dutch disease.

 While others have called for the diversification of their economies in order to reduce their dependence on natural resources (Auty, 1994, Collier, 2000), others still argue that resource abundance countries should pursue an investment strategy that would allow investments to be made according to the countries absorptive capacity which is inability to tap into private capital markets for project financing, or public investment. But more importantly, public investment should be made to finance public goods and merit goods. Public goods are goods that are underproved by private sector in a market economy due to their being non-rival or non- excludable or both, and include national defence, the

rule of law, environmental protection, scientific research, infectious disease control, and basic infrastructure network. <u>Merit</u> goods are goods that on principle be available for everyone in the society for the sake of peace and justice, and include; basic health care, basic education, safe drinking water and sanitation, adequate shelter and nutrition, and social insurance for unemployment. More importantly, public investment must be based on a sound macroeconomic strategy which entails price stability, fiscal solvency, and the ability to service public debt. It is evident that natural natural resource earnings in low income countries must be put into public investments and not into increased private consumption (Sach, in Humphreys et al, 2007 pp173-193).

The second group of scholars have emphasized the need to identify the political and social changes that are required to overcome the resource curse. In their view, it would be futile to introduce policy reforms unless the political and social environments in resource-rich countries are transformed in the first place. However, they at the same acknowledged the difficulty that would be faced in the political transformation in the short-term. Mitra (1994) and his group who have adopted the behaviouralist line of thoughts, have accepted that it was most unlikely for the governments in resource abundance countries to overcome the resource curse until the political elites in those countries were able to have a change in the mindset.

The third group like Karl (1997), pointed out that 'neoliberal' preoccupation with the shrinking jurisdiction of the state as applied to resource abundance countries ignored the crying need for strengthening the authority of the state in the management of resource utilization. Instead of trying to reduce its economic role, focus should be in undertaking measures that would strengthen the professionalization of the civil service and reducing the rampant corruption. Auty (2001 b) on the other hand argued that economic policy success depends on the building of a developmental state. It is only when measures to build social capacity, and a political consensus in the exploitation of these resources in

resource abundance countries are taken, that these countries will be able to manage conflicts caused by the economic shocks.

A fourth group of scholars had suggested the privatization of the natural resource sectors, as the only way that would forestall the problem of rent-seeking as argued by Ross (2001 b, 2000) while at the same time raising concern that such privatization may not be the most appropriate strategy for the forest resources sector. But judging the experience in some of the African countries, privatization of the sector had not only accelerated the rate of plunder and rape of the continent's abundant resources such as oil and minerals, but had handed over the rights to use mineral resources to foreign companies. In other words, the key to the "deposit box" itself. While the group to which the World Bank, IMF and the WTO also belong still support the doctrine of free capital mobility which has abetted the diversion of natural resources, and as money flees the country of the resource-rich countries do not benefit as would have been expected. Inspite of this, the international institutions argue that various actions should be undertaken at international level to help resource abundant developing countries to negotiate and implement some of these proposed measures in order to overcome the resource curse, and to make the industry more profitable.

But given the behaviour and history of the World Bank, IMF and even the WTO, this would be an exercise in futility, as the interest of these international institutions is to keep the African resource -rich countries in the dungeon of raw materials production and export, and to stay in this prison by not undertaking value-addition activities at home. Indeed, the contractual agreements that have been fostered by the World Bank between the minerals and oil producing and the international oil companies have been structured in a way that benefits the companies than the government. It is worth recalling here once again that until 1992, state owned mining companies had largely been left intact. But by the publication of the World Bank: The Strategy For African Mining that year, marked a policy change, as it was argued that public ownership of mining was a

hindrance to attracting foreign direct investment, including all that accompanied the strategy of dismantling of public company and installing market discipline, in order to reduce risks to private capital; improved mining code that gave investors access to mining rights, in one word, giving away the keys to the 'deposit box' itself and exclusively directing production to export rather than value-adding at home (Moody, 2007). Indeed when governments privatize natural resources, the firms in extractive industries often minimize what they earn for access to resources which make governments to receive less than the full market value for their minerals. This, as a matter of fact, increases corruption, as connivance between the government officials with those diverting resources away from the public good get out of hand..

In our view, and based on the available information at the African level, all the recommended actions and policies are at best palliatives and still cater for these countries to remain as exporters of raw materials and nothing else. This is the gospel that has been preached for thousands of years, in sharp contradiction to the 'incontrovertible' evidence that "countries got rich because for decades, often centuries, their states and ruling elites set up, subsidized and protected the dynamic industries and services."(Reinert, 2007, xxviii). But, this is what colonialism sought to prevent and has continued to prevent in Africa, even during post-colonial period through the intervention of the said international institutions.

Furthermore, the curse is not the abundance of natural wealth, but the curse is the failure on the part of the African countries to put in place the necessary intuitional infrastructures, and to build the requisite capacities and capabilities that would enable them to utilize the continent's resources in a manner that would add value and benefit Africa in the use of its abundant resources, as other countries have done. The 'intellectualization' of nature's gift as curse is to divert attention from the real factors that prevent African countries from realizing benefits in utilization of their natural resources – as it were to castrate the African people's mind. The use of the word curse becomes the imperialist advance detachment as it prepares our peoples for the fatalistic and resigned

acceptance   that resource abundance is a curse, taking advantage of Africa's weakness in embracing any idea that is floated by Western countries   without asking any question. In other words, the use of the term resource curse is an attempt to weaken and to wrench the control and ownership of the mineral rich tracts from the communities.

The concepts of resource curse or conflict theories have been introduced in order to drive home and to fulfil the desire of those who would like to continue exploiting these resources, by installing doubts and creating geography of conflicts where constant threat either created through militarization or self inflicted can thrive. Hence the prayer: "May God give us chaos, in mineral rich countries, so that we can continue to plunder their resources" (Lahiri-Dutt, 2008 p.1). To keep African countries trapped in the production and export of raw materials is to guarantee their underdevelopment. The acceptance of any given idea without raising questions, is in our view the greatest curse and not the abundance of resources. Instead of African countries focusing on addressing the key issues that would enable them to overcome and unlock the problems of underdevelopment and to put a halt to being exploited and humiliated as beggars, they allow their attention to be diverted away from the real issues through drummed up and flimsy concepts. Time and again throughout history, when African countries wanted to manufacture their products for exports, they were told to diversify their exports production to other raw commodities as new markets for their products   would be found in Europe. So instead of using our mineral resources as a blessing, we are being told that mineral abundance is a curse. This is our modern historical parallel.

The United Nations Economic Commission for Africa (ECA) in this regard observed that the quality of institutions determines the development gains from mining, and that the root cause of Africa's resource 'curse' is poor governance and not the mining activity itself (ECA Policy Paper No. 1, undated).   This observation confirms that other factors are only explanatory aspects of 'resource curse' and that abundance of natural resources can only be but a blessing. Further, Joseph

Stiglitz (2007 p.41) has stated that "there are incentives on the part of the multinationals that go in quite the opposite direction, and that in the past, their actions have sometimes undermined democracies and contributed to pervasive corruption, one of the defining characteristics of those countries with the resource curse". Indeed, since the resource is not inevitable and that there are much that can be done by the parties concerned would be to ensure that people lucky enough to have an abundance of resources should be able to enjoy the fruits of their countries' bounty.

6.3.10. Legal Framework for Mineral Wealth Exploitation

This section intends to highlight the trends and the main features of the legal regimes, concessions or contracts that govern natural resource utilization between the foreign international companies, governments or national companies and the local communities in the developing countries, and to examine the role which these natural resources can play in addressing the poverty which afflicts a number of poor African countries. The legal arrangements or concessions and contracts that have been offered to or signed with the multinational or transnational mining corporations is critical in this regard. The process of negotiating an oil contract and the type of contractual relationships will determine the outcomes for the country government. While there are many ways to structure the relationships in the petroleum sector, it has been observed that there are only two main families of petroleum fiscal regimes, namely: "concessionary" systems and "contractual based" systems. The first family-"concessionary" systems is when the government grants the company the right to take control of the entire process form exploration to marketing within a fixed area and fixed period of time. The second family is the "contractual based" system which consists of two groups: production sharing contracts and service agreements, and the distinguishing characteristic of each family of contract is, where, when and if ownership of the hydrocarbons transfers to the international oil company.

The ability of a country to attract international company investment depends on its prospecting and stability as well as its marketing skills. In all these endeavours, the contracts remains the best indicator on the basis of how well the different goals of a country's government and international company have been met. But in the absence of no single clause in the contract that tells one whether the country or the company obtained a good deal, a number of conditions will have to be met. Some of these will include: the degree of risks; the greater the risk the greater of bids of bids possible and as risk diminishes, the terms tends to be fairly fixed; the negotiating method which to a large extent depends on the negotiating or bargaining power of the country and what it expects the international company to accept. In this respect, the best practices can be borrowed from the existing experiences. The last requirement is need for complete transparency, which remains the best way not only to control expectations, but also to promote a healthy business environment in the extraction of oil or mineral resources.

Regardless of whether the multinational operators in natural resource sectors are public or private, their focus has been on the speedy maximization of their profits in total disregard to the welfare of the local people.   At the heart of the contracts, is the need to secure full value of mining for the host government and its citizens, while at the same time providing incentives to attract investments and to ensure that exploration and production will be undertaken efficiently.

This is particularly tricky in natural resource extraction, where numerous uncertainties regarding geology, costs, technology, resource price, and the capabilities of foreign or "local firms" and local human capital with requisite knowledge must be taken into account. This has produced a situation in which the international mining companies know more "about the value of the good being sold than the government of the resource rich country" (op sit Humphrey's *et al*). This at once makes it difficult to strike a fair deal that would be beneficial to the country in general. It is also obvious that the contractual agreements as presently concluded are being done within the framework of total ignorance of the

resources that African countries have underground in terms of their quantities and qualities.

Indeed in the absence of petroleum or mineral laws that are just now in the process of being drafted for the country at this point in time, what may be available are some ad hoc contracts or concessions that had been signed to facilitate the giving out of licenses in order to carry out the exploration activities in the country. In this kind of situation, the government is at a worse informational disadvantage, because it knows relatively little about the technical details of mineral resources and has absolutely no experience in handling the complex negotiations that characterizes the mineral resource sectors and which has stated is one of the conditions for sealing a good deal. This also requires that some basic principles should be observed, namely:

a. The process for government allocation of contracts should be carefully designed;

b. Technical competence, capacity and financial capability of the firm should be important criteria for careful and robust vetting, for prequalification purposes;

c. The true owners of the firm and their sources of funds should be known; and that

d. There should be strict rules to prevent public officials steering business of the firms in which they or their relatives and proxies may have financial interest-transparencies.

Indeed, transparency apart from preventing government officials from agreeing on terms that the citizenry cannot politically accept, it also provides a useful public participatory mechanism which is achieved by pursuing a more flexible negotiation process than is normally favoured by oil companies (Radon, 2007).

However, within this context, the consequences of asymmetries in information is such that those with inside information know what to bid, whereas those who are informationally disadvantaged will bid less than should otherwise be the case. This will make them suffer from what has been called "winners' curse": the fear that they will only bid too much only if they bid more than "the informed" bidder, resulting in a situation where companies trim their bids down knowing too well that this will on average obtain them the asset at a lower price, while the governments receive much less. The four principles cited have not been followed as the auction of oil rights, for example have been carried out under informal processes such as first come first serve or other processes equivalent to "beauty contest", in which companies submit explorations or development plans in an ad hoc manner. In other words, there is need for clear rules of the bidding processes to be set up if the potential benefits and corruption mitigation are to be eliminated. (Campton, 2007).

It is interesting to note that the Task Force set up by Cabinet Secretary of Mining to look into the 43 firms whose mining licenses had been revoked, was to examine whether the relevant authority had exercised their powers within the Mining Act to ensure that compliance with the laid down laws and procedures in issuing mining licences had been respected. The task force found rampant irregularities that span from issuance of exclusive mining licenses to firms that possessed no prospecting rights, and even to companies whose financial capabilities could not be established.

This was perhaps completely understandable as there had been no clear policy on mining, even what could be properly defined as mining law. But herein lies the danger as there a high likelihood of issuing licences to fake companies or those which want to use them for speculation only. The companies that had been issued with the mining licences or exploration permits which had breached the terms of such permits or licensing include:

a. Cortec Mining Kenya Ltd, which had been licensed to mine multi-trillion shilling nobium and rare earth metals at Mrima Hills in Kwale County.

b. Base Titanium which was licensed to mine titanium in Kwale.

c. Dangote Quarries Kenya Ltd… is associated with Mr. Aliko Dangote.

All in all, a total of 15 companies had been issued with mining licences while 28 were at various stages of consideration for different types of licences (Saturday Nation, October 5, 2013).

What is evident from the Balala approach is that the informal processes such as "first come-first serve" basis lack transparency and were liable to favouritism and corruption which will in the end in undermining competition and fair issuance of licenses. The "beauty contest" approach will end having the same effects of promoting favouritism and corrupt practices. This type of ad hoc approach has the hallmarks of avoiding the use of auction methods to allocate these licences. It has been argued that auctions allocate and price scarce resources in settings of uncertainty (op cit.Crampton), since every auction will have to ask and answer the basic questions of who should get the items and at what price.

It is in this sense that there are formal and transparent methods of assignment. However the best auction design depends on two key elements: (a) the contract term of the licence (duration, royalties, tax obligations);and (b) the geographic scope of the rectangular blocks, specified by a pair of longitude and latitude coordinates and depends on the quality of the prospects. While the auction design is the process through which the auction takes place, the process itself should be specified well in advance of the issuance of tender and be open to all on a non-discriminatory basis.

The process should begin with public advertisement of the tender specifying the procedures of awarding licences, including bidders' qualifications and the auction rules and whether open or sealed biddings. And whether or not should

the auctions of multiple blocks be run simultaneously or sequentially, or should the bidding of the blocks be for individual blocks separately or for packages of blocks. The critical element of the design however remains in defining what is being bid for.

Whatever the approaches are used in the auction system, the government should be guided by the basic principles of: design, transparency, ownership and fairness. The principle of design simply means careful planning in order to obtain proper outcome. The transparency simply means open and transparent agreements which are openly arrived at. The third principle of ownership is fundamental in that developing countries should remain the ultimate owner of the national resource. Finally, the concept of fairness literally means the natural resource rents belong to the country and that foreign companies should get only a fair rate of return that is adjusted for the risk they face. This also implies that contracts should also provide that increases in price oil or minerals should go disproportionately to the developing country.

Since the draft mining law is not in the public domain, the media becomes the only source of information. One of the proposals in the new Draft Mining Law is the introduction of a graduated royalty system that will require the firms mining high value minerals to pay more royalties (*Saturday Nation*, July 20, 2013). The special mining license which was issued to Cortec Mining Kenya Limited to mine "rare earths" for a period of 21 years required the company to pay 3 percent royalties to the government, the mining license which had since been revoked. Under the country's new draft mining law requires that 80% of their earnings accrue to the central government, 15% to the County government and 5% to the local community.

In the discussion that followed, the new draft mining bill slightly adjusted the old one and proposed that national government should retain 75% of the earnings, the county 20%, while the share for community should remain the same at 5%. There is no gainsaying that the country's mining laws are still outdated, and need

to be overhauled. Furthermore the Mining Cabinet Secretary said that the Government would establish an audit and an evaluation agency to determine how much would be extracted, to calculate what the government should be paid in terms of royalties and taxes. What has not been explained is how the true wealth of a resource-rich nation can be calculated that takes into account earnings, the depletion of stocks and the degradation of the environment. Further, will attention be paid to increasing the GDP, but in which most of the profits went to foreign owner would be less attractive from net national production (NNP).

It was in this context that it appeared inconceivable for the Cabinet Secretary of Mining, Mr. Najib Balala to state that the country was ready to engage mining firms on serious negotiations of these contractual agreements to reach a common position on how the sharing of benefits from mining would be reached. The real bone of contention was to do with uncertainty over the local ownership which is one of the key principles in every negotiation.. The draft bill does not spell out what form of ownership and the role of foreign investor in all this to recruit local workers. There were even claims that certain provisions had been sneaked into the law governing the sector to the effect that foreign investors should cede 35% of their shareholding to local people. How was such a percentage arrived at? According to the principles that guide contractual agreement is that developing countries should remain the ultimate owner of the natural resource.

6.3.11. The Secretive Nature of the Mining Contracts

A new International report on mining in Africa is very categorical that the mining companies routinely deprive the countries huge amounts of tax revenue that could be used in combating poverty and generate economic growth.The titanium mining project at the Kenyan coast, in Kwale and Kilifi counties whose deposits are estimated at 3.2 billion tones and accounts for 14% of the world's titanium resources, is likely to deprive Kenyans millions of shillings in revenue due to the secretive nature of the agreement signed between the Canadian Tiomin Resources and the government of Kenya. The arguments against the secretive

nature of oil or mineral contracts are compelling and are supported by empirical evidence derived from studies on transparency which suggest that "the first step toward reversing the oil curse is to remove the layers of secrecy that continue to surround so many aspects of the industry" (op ct. Humphreys et al, 2007 p.331) . The secrecy is only beneficial to a few people and comes at a great cost to the ordinary people. It is further stated that the day light robbery by the various African Heads of State in the rich oil producing countries would have not happened if the oil companies had been forced to disclose publicly their resource payments to petro-states (Global Witness, 2004).

This agreement also gave Tiomin Company the rights to mine titanium from Kwale to Kilifi, and that the company would be required to pay royalties at 2.5 % of the sales (*The Standard*, November 7, 2006). The draft mining bill proposed that the royalties was to be paid at a rate of 10% of gross revenue of mineral operations for diamond, 5% for precious metals, and at 3% for all other minerals. That the country lacks a clear mining policy can be seen in the production figures of magadi soda (soda ash) which was in excess of Kenya shillings 16 billion in 2012, but for which the government only received Ksh.16 million which was equivalent to 0.1%. This underscored the need for the country to develop a more coherent and comprehensive mining law.

The contract that gave Tiomin the exclusive mining rights to mine the metal was outdated and required an urgent review in order to ensure that the country would avoid the costly mistakes that had been made by other countries such as DRC where bloody conflicts had resulted in the displacement of an estimated 800,000 people. In Kenya, the land grab has added to the misery of dispossessed millions of people stretching from the Rift Valley to the Coast, who will be uprooted from their land as the country becomes a hotspot for oil and gas extraction as well as other minerals like gold and rare earth attract more international mining companies that are keen to tap into mineral, oil and gas wealth.

The country would do well to embrace a transparent way of mining by adopting a global initiative of promoting accountability in the management of revenues following the discovery of oil onshore and gas offshore ahead of their production if the country is to avoid unwarranted exploitation. The consulting firm, Hunton & Williams and Challenge Burpy Limited hired by the World Bank and the government of Kenya recommended that the country should move away from the tradition of keeping mining deals secret, and should amend the Petroleum Exploration and Product Act of 1986, even though the historical practice in the industry had treated oil and gas agreements with the greatest confidentiality. However since   many of the petroleum producing countries have abandoned the old practice and now publish their production sharing contracts, it is our hope that the Kenyan government would benefit more by embracing the principles of transparency.

First, it has been argued that lack of transparency will be costly to the corporation as the ensuing rights over oil or gas and mineral resources will not be secure. Secondly, the benefits to be derived even in competitive bidding that may not be optimal, transparency in negotiations would still yield multiple benefits. Lack of transparency is likely to exaggerated fears that a government did not get a good deal, hence suspicion of exploitation. Thirdly, transparency allows for more effective public oversight. This is because more oversight will strengthen government's hand during negotiations. Fourthly, transparent auction or bidding would allow for the selection of more appropriate rules for different sttings. Fifth, transparency can help in allaying fears concerned with political instability and policy uncertainties that are linked to oil and gas producers, while helping in avoiding the Dutch Disease.   Lastly, it has been stated that transparency is a precondition for the enforcement and implementation of the rule of law.

Even though negotiation of contracts normally take place between two principals, the third group, namely the affected land owners, often the indigenous community who normally demand compensation for the use of their land and the

disturbance of their property should be brought into the picture. The local communities that, until now were not on anyone's checklist should also be entitled to demand their part of the spoils in the form of jobs and payments. Indeed, the local community should be part of the overall contract negotiation; otherwise a climate of instability and conflict is likely to be created. It is in this context that the right of the indigenous people to be "fully informed prior to giving consent (FIPC)" to any extractive project before it can be allowed to proceed (Salim, 2003). This should be the norm; otherwise the communities will feel that they are being swindled and their rights abused, which would violate the international Labour Organization(ILO),Convention 169 on Indigenous and Tribal Peoples and the United Nations Declaration on the Rights of the Indigenous People.

The application of FIPC concept will only enhance more transparency as documents will not be falsified, and agreements signed in languages the local people do understand. This will stop the bribery of community leaders and halt the creation of bogus community organisations through intimidation of community leaders. In other words, dealing directly with the affected community is an essential factor in establishing real trust (Moody, 2001). In the Turkana county the communities were already demonstrating against the grabbing of their land, which was being sold off without being consulted. They demanded to know who had bought and fenced their land. In this connection, Mr. Isaac Longiti, a local politician was forced to call for land adjudication in the area, where for ages, no one had owned a title deed. Since time immemorial, the Turkana people had owned land under communal system and nobody had ever claimed ownership of a given portion of land. Yet today, their land had been stolen. (*Sunday Nation*, June 23, 2013). It was therefore time that the government through the National Land Commission (NLC) corrected the past injustices and issue the local people with the title deeds.

The absence of a formal mining law for the exploitation of natural resources and the lack of transparency in Kenya compounded the problem of getting accurate information. The country still uses most provisions of the old concessions or

agreements inherited from the colonial period whose main features included the use of royalties as the basis for financial payments to the host country. As already noted, these agreements were shrouded in secrecy as if the the African host countries were under oath not to reveal the content of these concessions or agreements. And yet, according to Charles O. Okidi (2007: p.12), these codes were readily "available only to foreign investors to exchange among themselves and that the concession agreements under these circumstances were wholly extractive, exploitative and underscored the dominance of colonial powers who controlled Africa and its natural resources". It is even more tragic that some of the new found "friends" in development still use the most opaque contractual agreements to exploit the African minerals and other natural resources. In an environment in which greed and secrecy become the order of the day, there is a crying need for us to change the way we manage our natural resources endowments. It is even more disheartening to note that despite the many United Nations General Assembly Resolutions, 1515(XV) of 15th December, 1960 and 1803(XVII) of 14th December, 1962 which at the beginning of African countries' Independence declared that: :

1. The right of people and nations to permanent sovereignty over their natural wealth and resources must be exercised in the interest of their national development and for the well being of the people of the state concerned; and

2. The exploration, development and disposition of such resources as well as the import of the foreign capital required for these purposes, should be in conformity with the rules and conditions which the people and nation freely considers to be necessary or desirable with regard to authorization, restriction or prohibition of such activities.

Furthermore, the Report of the United Nations Conference on the Human Environment held in Stockholm in June 1972 also declared in its Principles (V) and (XXI) that:

1. The non-renewable resources of the earth must be employed in such a way as to guard against the danger of their future exhaustion and to ensure that benefits from such employment are shared by all mankind; and, that

2. States have, in accordance with the Charter of the United Nations and the Principles of International Law, the sovereign rights to exploit, their own resources pursuant to their own environmental policies, and the responsibility to ensure that activities within their jurisdiction or control do not cause damage to the environment of other states or of areas beyond the limits of national jurisdiction.

3. The African countries have neither taken action to implement these nor developed well-defined mineral policies and laws relating to prospecting, mining, and marketing, utilization of these oil, gas and mineral resources. This has impeded the development of the African continent. However, this trend is beginning to change.

4. In Kenya this could not have come at an opportune moment, as the Ministry of Mines was attempting to grapple with and to update the country's mining laws. The current mining practice is regulated by the use of the Mining Act of 1940 which has been criticized for not only failing to address current and prevailing challenges, especially in the generation and sharing of revenue, but also for not addressing the plight of the communities that are likely to be displaced by the mining activities or who live around the mining areas. In an attempt to correct these anomalies, the government decided that the new Mineral and Mining Bill should be benchmarked with the best practices in other commonwealth countries in the region, including Botswana, South Africa, Namibia, Uganda, Tanzania and Ghana.

Since the country's mining laws are outdated and date back to 1908, one would also hope that the new mining laws would incorporate and take into account the

new developments that have taken place in Africa and at the global level. At the African level, it is some of the key provisions of the African Mining Vision (AMV) that the country's new mining law should take into account. The AMV for example states that:

 "For the mining sector to improve its contribution to broad based development, it must be integrated into the national and regional economic fabric through linkages; and that

to harness linkage opportunities, challenges such as those relating to deficiencies in human capital formation, particularly in knowledge intensive areas, as well as infrastructure inadequacies must be addressed; including, Africa's efforts to transform the mining sector away from its colonially created enclave features" (AUC and AMV, 2009).

What was even more puzzling was that the Cabinet Secretary of Mining, Mr. Najib Balala was still articulating the same old colonial mining model that addressed the exportation of minerals in their raw forms and of not processing or adding value before their exportation. However, even those countries whose examples would provide the best practices that Kenya could copy, had themselves not escaped from the World Bank's influence in the formulation of their own Mining laws.

In line with its 1980s and 1990s Structural Adjustment Programmes, and the 1992 Strategy for African Mining the new set of mineral codes as proposed by the World Bank and the IMF would not only update and reform the existing mining investment codes, but would also undermine regulations dating back several decades (Remy, 1991). Apart from instilling free market discipline, it would at the same time ensure, that public ownership of mining enterprises would be left under the control of foreign mining companies, and that the production for export rather than value-addition at home would be continued as has already been highlighted.

The foreign mining companies had placed greatest interest on the Bank's work with individual countries to update and reform the existing mining codes that would facilitate their investments in Africa by reinforcing the myth that efficiency, elimination of corruption and welfare maximization can be obtained only through privatization. Yet the Bank knows that credible privatization can only occur after only institutional infrastructure, a developed legal system, a tax administration regime that could collect revenue, and a financial institution that could provide money to finance the needed investment had been put in place (Stiglitz, 2002 and Freeland, 2000). While it was hoped that privatization would solve these problems, what came to pass in the last two decades has made it abundantly clear that privatization does not eliminate scope for corruption, or eliminate the agency problems. The returns to corruption are higher as there is now a wider range of hard-to-direct mechanisms for diversion (op.cit-Humphreys et al).

While the World Bank would like the Private Companies to be the sole actors in the mining sector, it would be foolhardy on the part of the African governments or Kenya government for that matter, not to use public sector enterprises to develop their resource base, either in whole or in part. In as much as the World Bank may demonise the public sector enterprises. In the interest of economic development of the African countries, in general, and Kenya in particular, these public companies are the only way to go due to a number of reasons. First, state owned companies will be handy in the development of domestic capacity and support the development of domestic linkages between the oil or mineral resources and the other sectors of the economy. Second, state-owned enterprises will provide viable vehicles for countries to build and help in knowledge creation (especially in basic science) that would enhance their own expertise and professionalism. Third, state ownership will allow the government to exert pressure and direct control over the pace of resource development. And while we admit that state-own companies have performed poorly in the past, this is not however, a sufficient reason to throw the baby away together with the basin of water.

What is therefore required of state-own enterprises to do is that they should adapt to the ongoing changes within the global economic environment by:

a. Restructuring themselves in a way that make their decisions making processing more transparent and subject to markets tests, and to do away with flagrant abuses from the privileged positions.

b. Managing ownership through commercialization of relationships such as shareholding.

c. Facilitating transparency by having the State-owned company organized as a separate legal entity with clearly established authorities and objectives

d. Making themselves more accountable to the people who are the real shareholders and owners of these enterprises.

e. Learn by borrowing from the best examples such as the Trinidad and Tobago model and the Norway model of state oil company.

Greater emphasis must be put on the state participation in the extractive industry through state owned enterprises, which would ensure that the benefits of natural resources would flow to the people under the assumptions that the state controls much bigger stake in the use of its natural resources, and the role of those who capture the state is also under the control of the state.

Over the years, the multinationals companies have perfected their financial and management tricks to ensure that they achieve their objectives of siphoning the countries mineral values into their foreign-held accounts, while pretending not to violate the terms and conditions of their mining codes. While this kind of analysis is beyond the purview of this study, the purpose of this section is merely to underline that utilization of the mineral resources at the national level is presently mired in problems with all the hallmarks of breeding conflicts and poverty. The

invisible inequalities in which noticeable extremes of wealth and poverty exist in what is widely perceived to be a rich country will exacerbate add fuel social unrest as the huge   in-migrations associated with oil production and different nationalities to the already unstable mix of higher expectations and dislocations. What then is the trend in the state of mineral contracts, codes or concessions between the multinational companies in the context of Kenya, an African state that has not been categorized as a major mineral producing country in Africa?

While in the 1960s and 1970s the mineral production in Kenya consisted of: barites, copper, feldspar, gypsum, soda ash and vermiculite, the most recent mineral production in the country for the period 2004-2008 is captured in Table 1 of this study. The table indicates that although the country has been a major producer of soda ash for years, it has not benefited from its exploitation.

As indicated in section two of this paper, the country is beginning to emerge as a major mineral producing country based on the latest discovery of oil in many counties: Turkana, Garissa, Isiolo and possibly a few others – this hydrocarbon which for the purpose of this paper is considered under minerals. The discoveries of huge deposits of rare earth metals, including niobium, a rare mineral, and titanium, gas, coal, iron ore now places Kenya in the category of mineral producing countries. These recent discoveries hint to the same dilemma that African countries have continued to face, that of increased dependency on the extractive industries. Kenya will not be different. The experience is that the present use of raw materials as mineral resources in their raw form will add nothing new to economic transformation for the country. So the abundance of oil and other mineral resources will only lead to social and economic problems. Indeed, even if we assume that the oil find in Kenya could dramatically increas the quality of living for the forty million Kenyans, it is still important to note that if the income derived from oil sale is used for consumption it will not be sustainable since the income depends on the depletion of a finite stock. Unless proper investment on the resources obtained from mineral or oil is made, the country will end the same way as before.

In 2007 a "Policy Big Table" organized by the United Nations Economic Commission for Africa (UNECA) and the African Development Bank which, brought together the African Union (AU), African countries and international organizations noted that, the scale of reforms in Africa since the 1990s'did not have any historical precedence', but concluded that Africa had not gained the best possible benefits from the exploitation of its natural resources. This situation had been made worse in the 1990s "by African efforts to attract FDI to exploit their natural resources, which led to the formulation of an overly generous investment laws and regulations' (UNECA, 2011, p17). But for whom?

Indeed, the neutrality of the World Bank as an honest broker has been questioned in its dealing with mineral investments in African countries. M.A. Thomas (2003) had noted that, historically, 'the Bank's approach to the extractive industry (EI) sector appear to treat increased private investment as the primary goal and a good in itself', while in reality, the EI sector can bring little public benefit but can leave long-term costs as resources may be extracted too quickly without due attention being paid to the environmental impacts.

It is therefore puzzling that Kenya can still invite the World Bank to assist her in formulating its new mining policy against the World Bank's well-known *negative* history of intervention in sub-Saharan African countries during the 1980s and 1990s. Even South Africa which Kenya would like to use as one of its best examples under its Black Economic Empowerment Programme (BEE), would not provide a credible alternative that should be emulated. First, because the mineral legislation in South Africa reflects obeisance to the big mining houses, by conceding that the introduction of sweeping changes in the mining sector would destroy investors' confidence whereas the purpose of the legislation in the first place, is to protect the country's resources outflows.

Second, was an imposition of royalties varying from 1% to 8% to be levied on diamonds, while gold and platinum were assessed at 3% and 4% respectively (Mineral and Petroleum Royalties Bill, 2003).

The third most important but decisive piece of legislation that was opposed by the Chamber of Mines, representing 90% of South Africa's mine owners who argued that the granting of land title deeds to the tribal communities and the introduction of royalties would quell investment (Pratt, 2003). After much debate, the South African cabinet settled to levy an average of 3% on revenues and proposed that royalties on gold and silver be slashed by half. While the BEE was to be a model for both Africa and the other decolonising states elsewhere, it failed to fulfil its early promise. Instead, BEE only succeeded in entrenching inequality in South Africa, as the income of the top 10% of black earners increased by 30% while the incomes of the bottom big percentage decreased by 40% in real terms. This, in the words of Moeletsi Mbeki was "a device for white-dominated corporations to build bridges with the ANC ruling elites", and not creates wealth or add value to the economy (UNDP, 2004; Moody 2007, p.58), but to create a major opportunity for resource diversion in the pursuit of self interest.

In a rush to formulate new mineral laws for the country which should have been done years ago, it becomes suspect given the secretive nature of the African governments. The contracts must have been signed by all the mining companies that have been in the country. Therefore, the ministry of mines ought to have an all inclusive consultations with all stakeholders including the local communities and county governments. However, since the current Kenyan parliamentarians have not demonstrated depth in discussing issues that are of great national interests, and have displayed the unique ability to be compromised on strategic national interest, the ministries of petroleum and mining would do well to take their time in formulating new mining codes that would correct the past mistakes, while at the same time, taking into account the prevailing global environment.

This becomes critical as the country moves to the next stage of becoming an important mineral and oil producing country. Indeed, the view of the Kenyan Commission of the Implementation of the Constitution (CIC), on the proposed Mining Bill 2012 for example does not only give a clear direction on the

compensation of land owners in areas where these resources are found, but does not address the principles of compensation for disturbance of land owners or lawful occupiers of land subject to a mineral right as required by Article 60(1)(b) of the Constitution which gives the sole power to land owners to decide whether or not they wish to be settled.

According to the CIC, the Bill has also failed the equity and transparency test as required by the constitution. It is against this background that this paper argues on the need for public participation in the discussion and formulation of the Bill before its enactment. The need to strengthen state- society links should not be overemphasized, as this will expand the scope for broad-based participation in decision making that affect their lives.

6.4. Are Community Rights Being Upheld or Abused?

Theoretically, those sitting atop lodes of mineral wealth should by definition be rich and be rewarded when the exploitation of these resources begin to take place. But the existing evidence points in the opposite direction, as the citizens who live where these resources are found, tend to be impoverished when they rely heavily on income from the mineral sale which subtract substantially, instead of adding to the improvement of their welfare. As if by a conspiracy of nature, they see their own resources sequestered or tainted and workers hired from outside the region to operate the mines. Indeed, given the capital-intensive nature of these mining operations, the mining companies are now capable of expanding into regions with complex ethnic, social, cultural and ecological characteristics in any developing countries.

In Kenya, where the development agenda has favoured only certain groups of people, and the income distribution has also been eschewed in the same manner, the discovery of oil or minerals will suddenly ignite the hope for those who wish to escape from the grip of poverty. It will also bring despair to those communities who live in remote and marginalized areas where these minerals are located. The striking of rich mineral resources such as rare earth, precious

minerals, niobium, iron ore, coal and oil in such counties such as Kwale, Kilifi, Kitui, Taita-Taveta and Turkana offer prospects for reaping huge benefits from the mining of these minerals. However, these benefits will be measured in terms of employment creation, income generation, and improvement in the transport facilities, electricity and water development, while at the same time it inflicts even greater environmental damage given the nature of the government in place and the high level of poverty.

And in a country like Kenya where the elite class are hell bent on grabbing everything, the concept of "mineral curse" is likely to be very real. Even though in our view, this concept should be linked to institutional failure (nepotism, corruption and inequitable distribution of revenue) which creates a situation to rob the poor, as the savage emasculation of royalties and tax regimes imposed by the World Bank/IMF add to the escalating misery of the poor (Moody, 2007). This will render the dream of harvesting benefits from the mineral and oil finds to remain a bitter dream! This is because people living in mining areas may feel that they have a particular claim on resource wealth and may be aggrieved as they see the wealth leaving their area and benefiting others (op.cit Humphreys et al).

Further, the capital intensive nature of the current mining operations, while enabling the mining industry to expand into regions with complex ethnic, social,cultural and unique ecological characteristics such as the Turkana county, Garissa and Isiolo and even Kwale to be possible. This will at the same time displace the local community that have not had any previous contact with the industry, and destroys their environment and livelihood. The examples below demonstrate how the abuse of communities' rights has been carried out in the quest to exploit their natural resources. The critical questions which remains is, who has the right to make the decision on how the resources in these areas should be used and what right should the communities have over the utilization of their minerals or oil wealth.

6.4.1. The Turkana County

In July, 2013 Tullow Oil Plc, the British Oil explorer revealed that it had discovered more oil deposits in the Turkana County (Ngamia 1). As a result of further discovery at Etuko 1 well, the oil resource level in Kenya was raised by 20%, from an estimated 250 million barrels to an estimated 300 million barrels, which was a rough market estimated value of Kshs 2.6 trillion of oil reserve.

Towards the end of that month, the company announced that it had started drilling at the sixth exploration well, Ekales 1 and that further tests would be carried out at the Paipal 1 where light hydrocarbon indications revealed possible presence of natural gas deposits that had been encountered during the drilling in March, 2013. Out of the five exploration wells which the company had drilled in the Lokichar basin in the Turkana county to date, it had struck oil in three wells; Ngamia I, Twiga South I and Etuko I, all of which were said to have significant amounts of oil deposits.

The fact that the country was being turned into a potential mineral and oil producing economy was confirmed by the rich mineral finds in other regions of the country as well. In Kitui (coal), Taita –Taveta (iron ore), Lamu (natural gas), Kwale and Kilifi (titanium), and (soda ash) to cite but a few. The details of minerals and oil deposits in the country have been reviewed in section (2) of this study.

Indeed, the country's profile as a top rare earth mineral producer rose a notch higher when the controversial Cortec Mining Kenya Ltd announced the discovery of rare earth deposits including niobium at Mrima Hill in the Kwale county, with an estimated rare earth deposits at US $ 62.4 billion and niobium deposits at US$ 35 billion or estimated Kshs 51.2 trillion. This would place Kenya as one of the top five countries with huge rare earth deposits in the World.

At the global level, the consumption of niobium was projected to increase substantially over the next twenty years as its demand will swell by 10% per

year due to its increased consumption by the steel industries in Brazil, India and China. The mineral is also considered as a "strategic" and "critical" metal to US national security because it lacks a substitute and of its limited availability. As Africa's mineral demand become driven by urbanization and industrialization of major economies, first, by USA, second by post-war reconstruction of Europe and Japan's economic expansion (Heap, 2005), and now by China's materials led growth. China, which is now the prime driver of world mineral prices is unable to meet its annual demand for copper, zinc, nickel and a range of other raw materials. China is almost exclusively reliant on Sub-Saharan Africa for its cobalt, manganese, and chromium.

As Lahiri-Dutt puts it; the people in such remote and neglected areas of our country are:

> *'by some irrational logic of nature have found themselves endowed with resources that they cannot or do not know how to deal with…………………and problem that could only be resolved for one and all if either state owned or multinational corporations take over the control and ownership of these resources and manage them by putting their profit first and taking over the control of what should rightfully belong to the communities' (Lahiri – Dutt, 2006p. 15).*

With all these developments, the communities' expectations have remained high as they expect to benefit from the mining activities through increased demand for minerals, investment in infrastructure, health and education, and other social amenities, including compensation payments. While this may offer hope to the communities, their overall impacts may be extremely limited as the subsequent analysis will show.

6.4.2. Employment creation

It is said that mining creates employment, but in the context of Africa where the use of labour is more prevalent , the use of capital intensive methods in mining,

which uses labour saving technologies makes its use in Africa more expensive as it reduces the number of labour required per unit output. This reduces the local employment opportunities that the mining industry is expected to create. Empirical evidence shows that high incidences of increased regional inequality, unemployment and poverty are prevalent in mineral dependent countries (Power, 2002). Indeed, in developing countries such as Kenya, the investment in the natural resource sector does not include upstream services or value-addition processing or the diversification of the economy into other sectors. This makes it difficult to overcome development related problems.

An oil exploration company, the British –based Tullow which is prospecting for oil in the Turkana County, stated that it would be offering employment to the local people by creating more jobs that would end the clamour for jobs and that would hopefully result in the creation of a conducive environment for peaceful co-existence. This, in the company's view would avert the tension that had been building up since the beginning of the mining exploration activities, and address what the locals claimed to be the "unfair" allocation of job opportunities by the oil firm.

A claim which the firm itself had acknowledged by admitting that it was rectifying the situation. The company's external affairs manager went further to explain that 80% of the people who had been employed by the firm were from the local community and that more than an estimated 700 jobs had been created for the youth. This enabled them to lay down their guns. This, however was not the position held by the local people. On the contrary, the local community held several demonstrations to protest against being sidelined, because preference was being given to people from outside the area, who were being employed at the expense of those who should benefit most from the project. The competition for jobs from outsiders was perceived to reduce the number of jobs that the local people could occupy. This creates social tension and mistrust among the local community about the government's commitment to help them benefit from oil extraction. Besides, what should be a normal practice is to have the hiring of

local workers and restricting the migration workers into the extractive region to be part of their licensing agreement.

However, given that the county is suffering from a very low level of education, and lacks people with skills, most of the jobs that would be given to the Turkana people would be those in the category of the manual workers with very low pay, as almost all the skilled, administrative and managerial posts would either be held by expatriates or people from outside the region. This literally implies that the Turkana local community would derive little benefit from the mining of oil. Further, the enumerated challenges would undermine the benefits of the training effect and the transfers of skills that the mining activities would confer to the local community. It is against this backdrop that, despite the wealth that maybe generated by the mining company and the relatively high wages that may also be paid to those working at the mines, many communities living around the vicinity of the mines, would still be anything but prosperous.

Arthur Lewis rightly observed that;

> …..*business management can be learned only in the practice of managing business, so if the foreigners refuse to employ the indigenous people in managerial positions where they may acquire experience, the foreigners may acquire and retain a stronghold over the economy. This is why so many countries in these days pass legislations requiring foreign businesses to employ at least a certain percentage of indigenous persons in supervisory jobs (Lewis , 1965p 259)*

Even though an attempt will be made to overcome these handicaps through education according to some of the community leaders who, at the same time, calling for the implementation of the company's corporate social responsibility (CSR) as a way of addressing some of these challenges, the real issue is that the contractual agreements that had been signed should have included the

employment of at least a certain percentage of the local person in certain supervisory jobs, including the training of the same in mining techniques and business management. Indeed, no excuse should be given that there are no lead people that can do the jobs.The hard reality is that the history of neglect as will be discussed in section 8 of this study make it more difficult to quickly correct these anomalies. It is also for these same reasons that it is being argued that it would be more prudent to leave the resources underground while the community as well as the country at large, builds the capacity and capabilities that would enhance their ability to exploit these resource wealths in a manner that would enhance sustainable development. Joseph E Stiglitz has argued that there are a number of important guidelines that the government could follow in order to obtain better value for their assets and that, one such guideline would be "to keep oil wealth in the ground than to sell it badly",(Stiglitz 2003,pg 23).

Doing so would enable the community not to be robbed and the country at large left much poorer by the extraction of its oil and mineral resources without fully benefiting from the utilization of their resources. It should be noted that these are finite resources and once it is gone it is gone. Indeed, while the new mining bill that was being drawn up by the Kenya Government may stimulate a mining boom, the sector still possesses very limited capacity to generate additional local employment because all the mining activities are still geared to the exportation of raw materials, and not to value addition that would add and trigger other industrial activities.

6.4.3. Development of Transport and Infrastructure

The location of minerals in such remote areas as Turkana County begs the question. But as Lahiri-Dutt puts it, the people in such remote and neglected areas of our country are:

"by some irrational logic of nature the indigenous people in these areas have found themselves endowed with resources that they cannot or do not know how to deal with in an orderly manner and where the problem could only be resolved

for one and all if either state-owned or multinational corporations take over the control and ownership of mineral resources and manage them in a systematic manner- in the process putting their profits first and taking over the control of what should rightfully belong to the communities" (Lahiri-Dutt, 2006 p.15) may open up the region by providing transport facilities, electricity and water development, however, the fact that the social and capital overhead would be geared exclusively to serving the mines, the roads that are constructed   directly would lead to the coast to facilitate the exportation of these raw materials; and the fact that the mining sector will not be integrated in the development of the Turkana county would also mean that the development impact of the mining sector on the county's economy would be very limited. These realities have not dampened the enthusiasm of the Turkana people who will, for the first time in their lives, be able to have access to electricity and possibly clean portable water and even some kind of tarmac roads. These side effects are perceived to be positive development in such remote areas.

Indeed, the location of mining concerns in remote and sparsely populated areas like Turkana, or north-eastern areas of the country automatically encourage the use of capital intensive methods in order to offset the added cost of constructing the necessary infrastructures to accommodate of thousands of workers who will be assembled in the area. Further, when the transportation system related directly to mining production which represents between 40 and 60 percent of the total mining cost, is subtracted as operating expenses, even though it does not contribute substantially to the general development of the county or country, and only acts as a conduit for moving the raw materials from hinterland to the coast for exportation overseas, then the overall impact of infrastructural development in the mining areas remains minimal. Further, the decline decline in the transportation cost, due to technological breakthroughs, has also dramatically changed the likelihood of mining ever becoming the basis for sustained economic development in the poor mineral producing countries.

This situation which is further worsened by the fact that mining activities exclusively remain export oriented enclaves and is not integrated with the rest of the economy, as African countries keep mining their resources for the needs and use of other countries and not for their own use. The experience is that low transportation costs have resulted in the 'dis- integrations of the mineral industry and other manufacturing activities and which make the shipment of ores, fuels and unfinished manufactured goods around the world cost –effective for further processing as finished products. This new development has destroyed the links between mining and other sectors of the local economies. Therefore, despite the discoveries of huge minerals and oil wealth, the emperor's new mineral and oil clothes still leave the emperor –the African countries stark naked.

6.4.4. Income generation

Closely related to this discussion are the secretive mining concessions that the country signs with the mining companies. In terms of GDP, mining in Kenya as of now contributes less than one percent. In terms of exports, the percent is still below the threshold that can enable a country to be considered as a mineral dependent nation. Tilton however notes that:

> *"The returns from minerals exploitation can be used to promote economic growth or development by helping in building the necessary physical infrastructure and more fundamentally, "mining and mineral processing can also generate jobs, provide opportunities for the creation of associated industries and provide other beneficial side effects or linkages for the local economy (Tilton , 1992 p.2).*

However, the present structure of our economies will make it difficult to achieve what has been set out in the above quotation.The Kenya's draft Mineral Bill proposes that the royalties be paid at a rate of 10% of gross revenue of mineral operations for diamond, 5% for precious metals, and 3% for all others.

It has also been proposed that the royalties on gold would be increased to 5% of gross sale value from between 2.5% and 3%, while those for rare earth, such as niobium and titanium ores would be increased to 10% of gross sale value, up from between 2.5% and 3%.The mining companies on the other hand have argued that these charges together with a 30% corporate tax will make Kenya to be one of the most expensive mining destinations in the world. This, they also claim will scare away potential investors, and may see the existing ones relocate to other friendly countries.

This view is debatable since the mining companies have been raking billions while remitting very little to the government. Besides, oil or mineral deposits are not a repeatable geological events that can be found anywhere either with similar qualities or quantities. This makes it difficult for the oil companies to blackmail if the country understands the game. But once oil is understood to be different from other sources of national income, to the extent that the preponderance of the income stream is a natural resource rent rather than return from reproducible capital such as factories or human capital, it would therefore be easy for the state to appropriate the natural resource income either through nationalization if it does not own the resource base, or even in situations where private owners are in control of oil fields. They will have to transfer licit and illicit shares of oil shares to the government as required by the constitution (Sachs, 2007). The draft Bill proposed that such benefits sharing be based on the following; the national government to retain 75% of the royalties, 20% for the counties, and 5% for the communities. In our view, these percentages should be reviewed and reversed so that the sharing of the royalties should be 75% for the community, 20% for the county and 5% for the national government. This should provide the basis for negotiations so that eventual figures that the kind of royalty payments that help the indigenous to live in dignity would be agreed upon.

Furthermore, all taxes and royalties that are derived from the mining operations traditionally go to the central government and the only benefit from equity that

the communities could expect to receive were those that trickled down through the central government spending. For example, in Tanzania where there have been massive tax exemptions and remissions given to the mining companies, is said to have denied the country significant amount of revenue. Between 2009 and 2010, the country granted tax exemption equivalent to 2.3% of the GDP or Tanzanian shillings 695 billion (US$ 432 million), an amount which was more than half of the US$ 808.2 million (Tsh.1.3 trillion) which the government planned to borrow from commercial banks for the financing of the infrastructure for 2011/2012 period (The East African, October 19th. To 25th, 2013).

For the communities, the 'trickle down' has never worked in Sub-Saharan Africa, as those who bear a disproportionate share of the cost of mineral development and do not control its utilization end receiving an inappropriately small share of the economic and social benefits. As witnessed in Kenya, the non-equitable sharing of revenue and resources has aggravated inequalities within communities even before any serious mining operations begun. The fact is that most of the communities in Kenya still live in pre-historic era and in sub-human standards that is beneath human dignity. As observed "even when resource rich countries have done fairly well, they have often been plagued by rising inequality-thus they become rich countries with poor people", (ibid.pg 2, Humphreys et al). The prospect for deriving benefits from mining activities therefore does not look good. Empirical evidence has shown that mineral-driven and resource –rich countries were among the poorest economic performers between 1960 and 1993 (Auty, 1998). The study undertaken by Oxfam also confirmed that the proportion of people living on less than one dollar a day in rich mineral exporting countries rose from 61% in 1981 to 82% in 1999 (Oxfam, 2003).

 In Turkana, 9 out of 10 people live below US $1.25 a day (The East African June 29-July 5, 2013). The United Nations Human Development Index (HDI) illustrates higher degree of variation in well being across resource rich countries (Human Development report, 2005). Among the lowest ranked countries in the world are those found in Sub-Saharan Africa, namely: Equatorial Guinea,

Gabon, Republic of Congo, Nigeria and Angola. Chad however comes in close to the bottom at 173 out of 177 countries. Yet these are some of the countries with astounding heights of corruption, where billions of dollars representing high percentages of oil revenues disappears every year. In Congo Brazaville Elf Aquitaine financed both side of the civil war and helped to mortgage the country, future oil income in exchange for expensive loans (op.cit, Karl, in Humphrey's et al). Experience shows that foreign controlled mining companies do retain all the proceeds of export sales except for those they spend on meeting the operation outlays in the country. "Since most of the petroleum and mineral exports of developing countries are under the control of transnational companies, the value of export are not the same as foreign exchange earning that is accruing to the producing country" (Mikesell, 1971).

This hidden repatriation of capital by the foreign mining companies and their expatriate employees hardly equates with the inward flow of fresh capital. In Ghana for example, where minerals represented around *40%* of the country's total merchandise export earnings between 1992 and 2003, less than 3% of those earnings actually contributed to the nation's gross domestic product. This is detrimental to the country's mining industry. In such a scenario a country is left with no funds for the development of its economy.

6.5. Environmental Impact of Mining and Its Effect on Communities

Mining activities do accelerate the rate and degree of changes in the natural environment and its ecosystem. These activities do not only modify the landscape and have long term impacts on the workers, the people, and the communities living close to mining areas but also to the environment and the national resources due to their degrading physical nature, their use of chemicals and other harmful substances (UNECA, 2011). The environmental effects, through flaring of escaped gases, explosions or spills from extractive industries are influenced by the type of minerals extracted, the technology and technique used, the scale of extractive activities, and the location including the geological structure of the mining projects. To the extent that externalities and hidden

costs,in particular health and environmental cost, including the restoration of development area to its original conditions, the cost of rehabilitating these, if not fully born by the oil or mining companies will be of great burden to the government. Unless the government takes firm action, the oil companies will be left to go scot free. This literally means that the government will be subsidizing the oil companies to destroy the environment.

The lack of a strong legislation on environmental protection in Kenya can be seen by the failure by the government to articulate a clear legal requirement in dealing with negative effects of oil exploration activities including the restoration of the development area to its original condition should the companies not find oil or eventually halt their exploration activities. A case in point is when in the late 1980s and 1990s,the government of Kenya gave out a licence to AMOCO Company to explore oil in Chalbi area in Marsabit. It would appear that the government laid down no strict environmental legal requirement for the restoration or rehabilitation of the development area to its original state should the companies' exploration activities cease if it does not strike oil, or if it struck oil, and close shop when the oil runs out or is depleted.

In its special report, the Desert of Death, KTN in its programme of 10th October, 2013 showed how the failure of the company to take steps to restore the exploration area to its original state or to cap the exploration oil wells had destroyed the environment as the poisonous chemicals used in the exploration had oozed out of the ground contaminating the drinking water, killing both human and animals and resulting in high incidences of cancer among the local community. While we wait to establish whether the very high incidence of cancer is caused by the deadly chemical leaks into the underground water as a result of the company having not sealed off the oil wells, or whether the company also used the area as a damping site for its own toxic wastes or toxic waste from Europe or America, however what we do know for a fact is that chemicals used at the drilling stage of exploration are dangerous chemicals such as barites that can kill animals and cause cancer as indicated in Box 2 of this section.

Indeed, while African countries have been engaged in the mining activities for centuries, hardly any attention had been paid to its environmental consequences. As a result, the continent has been opened to all forms of environmental abuse, particularly for those who work and live around the mining areas and the general population at large. This state of affairs has been driven in part by the fear of the African countries loosing the so called investments in the mining industry,should they demand strict adherence to the environmental protection standards. It is also as a result of pure ignorance of accepting the negative long-term impacts and consequences of the mining activities as the unavoidable outcomes of any mining operations. This is a wharp-belief that, this is the price one is to pay for development, namely: that "one has to die in order to go to heaven". Yet some mining activities of the hydrocarbons such as oil or minerals like titanium and uranium are known to produce radioactive dust particles which have long term devastating effects on human health.

Furthermore, from an ecological economic perspective, there is a link between the increase in conflicts and the extracted, transported and utilized minerals around the world (Martinex Alier, 2002). The encroachment and degradation of environmental resources such as land and water which constitute the livelihoods for the majority of the population in developing countries remain a source of great concern to the local communities and the indigenous people, since mining is associated with deforestation, soil erosion, land degradation and the removal of large areas of vegetation which provide the very livelihoods of these people. It has even been argued that extracting and using fossil fuels containing hydro-carbons, and coal production for the generation of electricity also cause significant emission of greenhouse gases and leave footprints in climate change (UNECA, 2011 p 46). The mining companies which continue to extract high profits from Africa are not interested in supporting policies that will transform the continent into a developed entity.

With the support of their home governments, including UK, they have pressurized African governments to introduce policies that have resulted in communities being

dispossessed of their lands, environmental degradation and human rights violation, while yielding super profits to their national treasuries. This asymmetry of power between the mining companies on the one hand and African states and communities on the other is one of the many environmental damages being obscured by the heavy focus on aid and governance issues. Indeed, the main concerns for the African communities affected by mining are the dispossession of their ancestral land, repressive policing in support of the mining companies that keep farmers away from their fields and the unfulfilled promises of providing employment and improved lives from mining.

The continent's dilemma does not therefore only end at the African level, but continues, at the global level as well. The EU's bid for raw materials will end hurting African countries even more as the EU launches a new Strategy to address its dependence on imports of strategically important raw materials from Africa such as high-tech metals like cobalt, but also wood, hides and skins which have been labelled as critical to EU's industrial competitiveness and as Brussels strives to stop developing countries, particularly African countries from restricting the exports of their raw materials. This new strategy in fact threatens the freedom of developing countries and in particular, the African countries to pursue their own industrialization programme, which is based on value addition and the processing of their primary raw material in order to escape from poverty and aid dependence.

It has even been observed that as mineral resource productivity and demand increases in Europe, it is the African countries that will have to struggle to cope with the environmental impacts of the rising rates of extraction of these minerals in their countries as huge amounts of wastewater and dissipative losses mount (Kuhndt et al2008). This inflicts the worst environmental damage and the deepening poverty as the worst environmental pollution the world has ever known.

Notwithstanding the adoption of the African Mining Vision by the AU in 2008 as a strategy for moving Africa away from being a source of unprocessed minerals towards the production of value added products, the African countries are still trapped in the exportation of raw materials and are still following the colonial dictum of yore that:

> *"Because people in the plantation, being tempted with a free market for their growth over Europe, will all betake themselves to raise them, to answer the prodigious demand of that extensive Free Trade, and their Heads be quite taken off from manufactures, the only thing which our interest can clash with theirs (Dekker, 1744)".*

The Dekker 1744's parallels today's situation is extremely clear as a large number of Third world countries particularly the APC countries, have been de-industrialized during the last decades (Reinert, 2007 2004b). They have however been, kept politically at bay with promises of being able to export their agricultural and other raw material products to Europe and the United States, China, India and the emerging economies. Indeed, as Africans refuse to walk away from the dungeon of raw material exports, their future as underdeveloped countries is likely to be sealed forever!

6.5.1. Experience of Oil Drilling in Africa

When one talks of the impact of oil drilling in Africa, one is painfully reminded of the Niger Delta in Nigeria, where Ken Sarro Wiwa was hanged in 1995 for demanding better quality of life, clean air, the non contaminated water, and the protection of the environment which is the source of livelihood for the Ogoni people. The destruction of this very source of livelihood of the Ogoni people is marked by the contamination of their drinking water which has 900 times as much benzene and carcinogenic, deemed safe by the WHO.

The cauldron of abuses, which includes the lack of basic infrastructural facilities such as education, is, for example, reflected by one secondary school per

14,000 people (Ghazvinian, 2007). This happened as the former head of Exxon Mobil Company earned US$ 145,000 a day during his tenure, while more than 80% of oil revenue accrued to only one per cent of the population (Watts, 2006).This was part of global corruption in collusion with local elites----paradox of plenty indeed!   With 35 billion barrels of proven oil and gas reserves at the Niger Delta, it is the height of a mockery that the people in the area should remain mired in abject misery.

 A UN report further underlined the magnitude of the Niger Delta destruction by estimating that it could take 30 years and at least US$ 1 billion to rid the poisoned mangroves of the thick black cover of crude oil (Economist, August 13th.—19th. 2011). This amount which is peanut compared to what the Shell BP was forced to pay for the oil spill in the Gulf of Mexico. The dangers of oil drilling not only exposed corporate recklessness, but also the lack of care in drilling, which unnecessarily endangeres the environment and threatens thousands of jobs and livelihoods of those who depend on fishing and tourism in the area. Even though the victims were likely to receive compensation in the case of the United States, this would be, but a fraction of an incalculable loss of what they had suffered (Stiglitz, 2012 p. 189).

Indeed, the Niger Delta problem which is closely connected with international corruption where oil companies seek to maximize profits by lowering costs of obtaining resources and by bribing government officials at the expense of preserving the environment, can also be seen by the hiring of security forces either by government or private firms to protect the oil operations and the future revenues of one state. But the sad part of the story is that the security forces have caused severe human rights abuses, while communities have hardly any way to seek redress, except by holding hostage the producers and the production of oil (ibid.   P269, Karl in Humphreys et al).   The cost of such corruption to the national economy has been said to be enormous, as reflected by Nigeria's president Abacha's theft of as much as US$ 3 billion (Ayittey,2006), which is even now paled by the ongoing loot of the continent by the African

leaders. Indeed the over 50 years of oil production in Nigeria has neither generated economic growth nor prosperity, but has entrenched poverty, violence, instability, civil war armed conflict and state failure.

The drilling of oil has resurrected the spectre of oil curse and created what a former Venezuelan oil Minister called the 'devils' excrement'. The cruel irony is that Nigeria's annual per capita income of US 1,400 is much less than that of Senegal whose exports are mainly fish and nuts! It has stated that while the intensified struggle for oil in Africa is not a replay of the partition of Africa in the nineteenth century, yet the continent is still being haunted by King Leopold of Belgium's ghost. Its natural resources are being increasingly exploited by the competing transnational actors that marginalize and impoverish people in Africa's oil producing countries, (Obi, 2009 p 198)

In the Turkana County where the discovery of oil has taken place, the County, and in particular the communities living around the areas where oil has been struck, will have to bear the burden of environmental risks and consequences involved at every stage of the oil development as illustrated in Box 6.3 below.

Box 6.3: Stages of oil development and environmental impact

At the drilling stage- this involves a liquid phase which is modified with various chemical additives, both liquid and solid to align the performance for drilling conditions underneath the earth.

The drilling stage cuttings- which are pieces of rock particles that are displaced from the earth crust to create the hole and waste liquid are sometimes contaminated with crude oil, salt toxicity, corrosive elements, high electro-conductivity, and other chemical spills from the drill site.

If not properly handled-the cutting can also cause serious impact on the environment, wildlife, human beings and plants.

It is also highly probable- that impurities can be found in some of the drilling

chemicals such as barite which is a key drilling chemical and is known to exist with impurities metal contamination. Such impurities can kill humans, animals, birds and even plants when they come into contact with them.

Some of these wastes are said to contain above normal levels of heavy metals such as lead, mercury and cadminium. These chemicals are known to cause cancer mutagens, birth defects and other negative health impacts in human.

When it comes to the instigation of violence, the stage is already set as the community begin to ask what happened to the community ancestral land which has been fenced off by land speculators and grabbers. As the pressure for greater share of the oil revenue mounts and whoever has the right to the land was likely to have a greater claim to the regions new found oil wealth. The same story as in the Niger Delta was beginning to unfold, since oil extraction always go hand in hand with increased ethnic tension and political instability which result from forced out-migration and in-migration with its accompanying population pressure. Indeed, the existing tension and violence in the area coupled with the free circulation of firearms does not augur well for the exploitation of the country's oil resources. As those who always instigate and benefit from such kind of chaos are ready to quickly pounce on the concept of resource curse to make their kill, as the communities' attention is focussed on how to settle quarrels and not on how they can reap benefits derived from the utilization of this natures gifts.

In Narok county, the Olitokitok residents for example had opposed an investor's move to mine limestone, but their MP Mr. Katoo Ole Metito together with Mr. Navendra Raval, the chairman of the Cement Company had forced the community to lease acres of land to the company at ksh 4,000 an acre per year for 99 years, even though NEMA had warned against the building of the plant in the wildlife grazing areas and their migrating corridors. The mining of soda ash at Lake Natron in northern Tanzania by the Tanzania National Venture Development Corporation and India's Tata Chemicals, although creating 2,500

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direct and indirect jobs as well as infrastructure development, will be highly detrimental to the environment since the lake is home to millions of flamingos that hosts 75% of the world flamingo population, which is not only an important ecotourism asset for the Tanzania economy but to the Kenya's economy as well. The construction of the proposed plant will definitely impact adversely on Tanzania tourism and the environment. It will be of little benefit to the Masais'- the local community who can hardly be employed by the project or benefit in a sustainable manner, (The East African, February 23 – March1, 2009).

In Uganda for example, the oil find in the country's largest conservation areas – the Murchison National Park which is home to elephants, lions, giraffes, buffaloes and a variety of antelopes is likely to cause the great ecological danger. The Rubonyo forest within the Park which is home to chimpanzees and other rainforest creatures is bisected by the Nile River which is also host to hippos, crocodiles and water birds, and home to 52% of all African birds, Africa's 39% share of all mammals, such as chimpanzees and gorillas and home to 14% of all African reptiles, 31% of all its butterflies and 19% of all its amphibians. This biodiversity in the Albertine Rift is the backbone of the country's tourism industry which contributes to US$ 600 million a year, but stillhave an enormous potential to grow (The East African, 23rd. To 29th. June, 2010).

This amount of money is of course much less than the projected receipt of US$ 2 billion each year from 2 billion barrels of oil projected to be produced each year for the next 21 years. However, preserving the biodiversity presents an invaluable lifetime benefit to the people and the environment which is priceless. Indeed, when the calculation is made of the pollution resulting from oil, or chemical spills that may not only destroy the fishing industry, destroy forest and contaminate the drinking water, thus denying people of their environmental economic activities like arts and crafts, food, medicine, and ecological sources like water retention and soil conservation benefits, then it is at once clear that, the benefits to be derived from oil exploration will not be enough to compensate the incalculable loss likely to be suffered from oil pollution as witnessed in the

Niger Delta, Nigeria (The East African, June 28th. to July 4th., 2013). The two examples of the two East African countries have been dragged into this debate due to the integrated nature of these economies, which removes the shield of any country in the region from not being affected by the ripple effects of any of the economic activities. In any case, environmental spillovers have no boundary limits.

In Kwale County, the Tiomin company mining activities had displaced 1,500 farmers who had to be paid kshs 80,000 an acre, a very small sum of money in exchange for the loss of their ancestral land. In addition, payments were also made for the destruction of buildings and crops, for which the Canadian firm had set aside Kshs 600 million for compensation. But nothing is clear how this money was used, as an agreement between the government of Kenya and Tiomin had been reached without prior and proper consultation with the local community in the relocation of 378 farmers, which was to enable the company to have an immediate access to the entire Kwale mining site. As a form of compensation, the company constructed a number of infrastructural facilities at the new relocation site which was valued at kshs 325 million for the local contractor to build 2 schools, 8 churches, 2 mosques, health centres, dispensaries, social hall and a pipeline for the community water supply (The Standard November 7, 2006).

While this might look good at face value, it does not however fully compensate the communities who had been displaced from their land, their livelihoods, and suffered psychological trauma as a result of disruption of the community institutions and way of life and power relations. The new resettlements would require new skills which the community will need to survive. Apart from these incalculable environmental costs, the additional costs of pollution from the radioactive dust, titanium production and from radiation, whose effects may last for years and cause diseases whose impacts would have to be included.

The government of Kenya's reckless borrowing from China will add to the environmental destruction due to poor labour standards and further exploitation of oil and mineral resources to pay for the loans used for the construction of

infrastructural projects. This will cut back on the benefits and other investment activities that the communities should obtain from the exploitation of their oil and mineral wealth as Kenya gets entangled in the dance of the Dragons and as it mortgages her heritage for the sake of roads and dams!

From the above arguments, it is clear that when granting mining rights for the development of a mining project, it should be a requirement for those who have to develop a mining project to include in their application, proposals for the protection of the environment, the prevention of pollution, the treatment of waste, the protection and reclamation of land and water resources and the elimination and minimization of the adverse effects arising out of mining operations on the environment and the community. Apart from requesting the mining firm to bear the full cost of the rehabilitation of the mines, the new Act should also compel the holder of the mining rights to contribute to the Environmental Protection Fund in order to protect the poor. Further, the contracts should have provisions for suing parent companies that own some of these companies for environmental damages and violation of human rights.

At the African level an effort has been made to: "harmonising natural resource development policies with a view to creating a favourable environment for cooperative efforts by Member states in the development of their natural resources to meet socio-economic needs of their peoples" (LPA 1980-2000). The Big Table Meeting in 2007 also underscored the importance of environmental issues and underlined the need to involve the local communities and other stakeholders in monitoring and enforcing environmental compliance, At national level, not much has taken place as agreements on the exploitation of these oil and mineral resources have remained secretive. In Kenya, once the oil was struck, the people wondered, "how we will manage oil if we cannot even manage our water resources". In a country where the culture and appetite for corruption reigns supreme, it will become increasingly difficult for the communities in whose land these oil and mineral resources have been found to draw any meaningful benefit from the utilization of their own resources. It will equally prove difficult to

implement any environmental legislation that would minimize the negative impacts of the mining activities. But a start has to be made, as an all out effort is also made to uproot the culture of corruption.

6.6. Is It A Boom Or A Resource Curse?

6.6.1. Improving management of natural resources

The idea of oil or mineral resource being a "curse", is in our view not true. Nature's gift cannot be a cures but a blessing as it can offer an enormous benefits to an economy. The debate has missed the point as the proponents of the resource curse have not focussed their attention to the conditions that either prevent or bring about the proper utilization of these resources to the benefit of the people. In the context of developed countries which have the basic infrastructures and whose basic needs have been met, the use of oil and mineral wealth can only cause disease like the "Dutch Disease", but for the developing countries which lack the basic infrastructure and whose basic needs have not been met, the utilization of these same resources becomes a "curse". The same resource cannot cause a disease to one group of people and be a curse to another group of people. But since the resource curse is not inevitability, a lot can be done to ensure that everyone in the country enjoys the fruits of resource abundance.

The literature review of resource curse has thrown in a lot of light and while not conclusive, has however indicated that what should be addressed are the factors that hinder the resource abundant countries to the benefit from the utilization of these natural resources. Indeed an examination of the resource curse literature reveals that while extensive survey of resource curse literature link resource abundance to negative development outcomes, little of these research has adequately examined the role that social forces play in shaping those development outcomes (op.cit,Rosses). While there is hul-la-ba-loo about the oil find in the country, especially in the Turkana county, the country would do well to draw lessons from the residents of the Niger Delta in Nigeria, who sadly learned

that the oil boom had only suffering and greater dislocations- all in the context of higher expectations of the T urkana people.

Some of the factors that have been cited as causes of "resource curse", in our view, tend to concur with A. Schrank's (2004) findings that natural resource dependence may be a symptom of underdevelopment rather than the cause of resource curse. A view supported by Sorli et al 2005, when they state that oil dependence had not exercised a significant influence on the onset of civil war. The study of the Turkana county reveals that well before oil was struck, the area was already prone to ethnic conflicts, which fared up between the communities in the sharing of local resources, particularly over the grazing land. As stated above, the oil find will only add fuel to the already simmering embers of anger, violence and conflict.

 It is in this sense that it can neither categorically be argued that the oil find is the root cause of the resources curse, nor can we categorically state that resource abundance is the cause of poor governance. What can be said is that the distributive repercussions and the pattern of income distribution of the oil wealth exacerbate the problem of inequities in the sharing of oil revenue and other resources.

At the face of it, even if the construction of roads and pipelines which are labour—intensive may guarantee job creation and employment, but since these jobs are often carried out by the existing companies and government contractors, which normally prefer to use their own workers or skilled workers from other parts of the country, the prospect of employing the Turkana people therefore remains dim. Indeed, this does not therefore directly translate into job-creation for the locals that are directly hired from within the communities.

Moreover, these jobs are temporary, because once the roads and pipelines or dams have been constructed, there will be no need to retain the large workforce. On the other hand, the oil industry itself requires special skills that few Turkana residents would readily have, notwithstanding the protests by the local activists

who claim that Turkana people are just as well educated as other communities, and should therefore not be denied employment on this ground alone. But given the history of neglect that the Turkana people have been subjected to over the years and have as a result suffered from the low levels of education, the reality is that such wishes will only remain wishes.

Furthermore, since the contractual agreement had not included the requirement to provide on the job training for the local people and to provide employment as well. It would be difficult to enforce the company to offer jobs.

Therefore, the opportunities for local employment will only be higher in the lowest paying jobs categories due to the community's high illiteracy rate which is above 80%. This means that, well-paying jobs will be held by the people from outside the region who were already invading the area. In this kind of situation, the oil boom will only have limited impact in improving the quality of life for the local people.

Regardless of when oil will be produced in its commercial quantities, some visible impact on the Turkana County will still be evident, since roads and other infrastructures will be built. This will definitely help to strengthen and improve connections in what has been an isolated and remote area with the rest of the country. This is an aspect of the project which is likely to be received well by the communities.

In an attempt to improve the potential impact for oil exploration on the life of the local community, the government will have to commit itself to enhancing local participation in the ownership of the multinational companies through local firms. But the so called 'local firms' that have sprung up, are either owned by the elites whose only interest is to cash in the loot, or the local firms that are at best, the subsidiaries of the same transnational mining companies. Indeed, the government's statement of commitment to enhance local ownership does not mean much and will not help the local communities to be part of the process, but will create confusion in two ways. First, because the government appeared to be

backtracking on its commitment of enhancing local ownership by repealing the mining legislation passed in 2012 which required mining firms to have at least 35% of local shareholding. Second, many of the so called local companies with the technical skills and capacity to engage with Tullow are but the "Trojan horses" and "wolves in sheep clothing" because they are either partly owned or financed by the foreigners or the foreign firms do what they do best-that of robbing the local community and Kenyans at large. The language of deceit is therefore used with the vagueness and ambiguities that drive a wedge between the communities and inveigled them with promises of jobs, but which at the same time cause maximum confusion through the use of bribes and corruptive deals. This ends in causing chaos through the use of the word-resource curse. So as chaos reign, so will the plunder of the African countries continue!

The Turkana county residents will in the end be disappointed by the revenue to be derived from the oil exploration, namely: the amount of revenue that will flow into their county government. It is also not clear what additional revenue the exploitation of oil resources will contribute to the county or to the national economy. But what is not in dispute is the needs for local and indigenous people who live on the land where extraction takes place deserve to be given attention in the direct share of mineral or oil resources. A less controversial approach would be to adopt policies that narrow the income gap between the extractive area and the rest of the country.

Using a conservative estimate of the 300 million barrels so far confirmed, which is roughly equivalent to US$ 30 billion or Kshs 2.6 trillion at today's prices and even if small proportion of this amount is allowed to flow back to the county, it is likely to significantly transform the resources available for development in the county, since the allocation of resources would be done by the Commission of Revenue Allocation (CRA). If the oil revenue is added to the CRA's allocation then the county might be able to move from the lower income level to one of the highest income levels within a few years in relative terms. Takes would be done by the Commission of Revenue Allocation (CRA). If the oil revenue is added to the

CRA's allocation then the county might be able to move from the lower income level to one of the highest income levels within a few years in relative terms. However, the county administration has gone as far as demanding that exploration activities should be halted until the residents are given the guarantee that they would receive at least 25% of the proceeds.

The people of Turkana should in our views have even gone further to demand that the whole mining bill that allocates the percentage of the royalties in which the central government is allocated 75%, county 20% and community 5%, be revised or amended in a manner that would allocate the community the highest percentage followed by the county, and then central government in that order. In other words, the central government would get the least percentage. If this is not done, the community and the county that bears the greatest cost in terms of displacement including other environmental costs as will be outlined under this section, would not get a fair and a just compensation.

As a part of negotiation, the community should have even gone further to demand that the exploration of oil should be halted until such time that, the residents and the country as a whole is able to build the requisite capacities and capabilities that would ensure that the communities and Kenyans at large, become part and parcel of the mineral development, to a level where they can undertake exploration and be able to develop and process their own minerals. Indeed, be also able to negotiate from the position of knowledge, the terms and conditions for the exploitation of the natural resources that are buried under their feet. Anything less, would be equivalent to handing over resources to foreigners on a silver platter.

6.6.2. A history of Neglect

Turkana which is the largest county in Kenya covering an area of approximately 77,000 square km, with a population of about 855,400 as per 2009 census, with a density of 13 people per square km compared to the national average of 66 has been forgotten in terms of social, education and economic development

by the three successive régimes since the country's independence in 1963. The three regimes followed to the letter the legacy left behind by the colonial power as demonstrated by the various economic indicators. The remoteness of the area is shown by the fact that less than 15% of the county is not urbanized. This makes it extremely expensive to provide the basic services, such as, electricity, water, education and health.

The county needs more basic services than anywhere else in the country: as nine out of 10 people live below the poverty line; 2.4% of households have access to electricity; and only 18% can read and write, compared to the national average of 66%. In the 1960's there were only two primary schools and one secondary school. It is an underdevelopment with a long history of government neglect. Denying the area the education was to disenfranchise the people and to deny them the means to acquire knowledge and to be informed. And to take away their basic human rights in combination with the denial of other fundamental rights including taking away of their land would be equivalent to the "aboriginalization" of the local communities or 2"internal colonisation" of the local indigenous communities 'terra nullius' As graphically stated by a Turkana pastoralist, "They blindfolded us with camels to feast on. We later realised they had fenced the place and settled to explore oil".- Lodongiroi Lopusmong Lopeto (The Standard, November 2nd., 2013 p30). The community non-involvement in the negotiation of the contract agreements was not important to the Tullow Oil Company, which exhibited arrogance and a don't care attitude by telling the community representatives and the local people that the company was not prepared to listen to them. The proper and transparent thing to do would be to involve the three parties in the negotiations.

The land grab in the Turkana County by the elites who had advance knowledge of the impending oil find in the area strengthened the concept of Turkana becoming the 'aboriginals' of Kenya as their ancestral home was taken away from them. Further, the construction of the Gibe dam in Ethiopia which will cut off River Omo which provides 90% of water to Lake Turkana without the

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government of Kenya raising the issue of the environmental impact of the dam on the local community reconfirmed the government neglect, yet the trans-boundary nature of the river required that the issue be raised. The government failure to respect international convention on the need to protect shared waters or river resources will see   the lake begins to dry up . It may even be turned into 'an aerial' lake affecting more than 20,000 people who rely on the lake for their livelihood.

The fishing industry will grind to a halt, and the economy will shrink as it now contributes approximately kshs. 300 million every year. Indeed, the dying of the lake will not be compensated by the discovery of the major aquifers of water in the region. While the water find also provides the good news and raises good prospects for economic transformation. Its utilization will still raise many imponderables that will have to be addressed in order to achieve an optimal balance between the management and the sustainable exploitation of these resources. Unregulated, it could further trigger land grab, massive land degradation, and rent seeking behaviour, causing conflict and blessing to the local community at the same time.

All these factors will have negative impact, generate considerable resentment and increase pressure on the oil companies and government to take some actions. But what type of action? As popular dissatisfaction begins to mount, the emergence of new sources of tension will be witnessed that have the potential to exacerbate political instability. Community leaders are therefore more likely to demand that the company give more jobs and provide other opportunities to the people of Turkana than may have been stipulated in the company's agreement with the government in Nairobi, since nobody was consulted before these agreements were signed. In the face of strong pressure from the grassroots the county government is likely to demand a greater share of the oil revenue in order to be able to assuage the anger and frustration of its people. The conflict is unlikely to be resolved because the political class in the central government also needs the money and as a result will not only be reluctant to surrender a

greater share of oil revenue to the county administration, but will connive with those in the private sector to take away what belongs to the community.

Furthermore, as the competition over oil revenue intensifies, tension between the different local communities over who has the right to land, will have greater claims to the regions new found wealth. This is the same story in the Niger Delta where oil extraction had gone hand in hand with the rise in ethnic tensions and political instability which spilled over into civil war where all actors laid their claims in the loot of the oil resources. A repeat of such a phenomenon is not far off and is lurking behind the scene in the case of Turkana, where such tensions will add fuel to the existing conflicts over grazing land, sharing of resources, population movements, political turmoil, including the stress of climate change. The escalation of violence is likely to occur in Turkana than in other parts of Kenya, as a result of free circulation of firearms and ammunitions.

In the case of Turkana County, it can safely be stated that nature's gift is not to be blamed for the rising tension in the County. This should be put at the doorsteps of the previous three regimes even the present regime that has ruled the country since independence. Indeed, what type of regimes were these that paid no attention to the well being of their citizens as narrated under this section. Even well before the country could be categorized as a mineral producing country, or joined the club of resource rich states, the regimes in power had developed authoritarian rule; obeyed no rule of law; were predatory in nature; had institutionalized tribalism and ethnicity; and demonstrated propensity to instigate tribal conflicts, especially during elections. It is in this sense that, it cannot be said that the negative development outcomes are the product of either the country's poor or rich resource endowments.

Indeed before this period, Kenya had not been known to have large mineral endowment. The country had not even managed the little resources it had in addressing the plight of its entire population in a more equitable manner, but concentrated the resources in serving the ethnic group that belonged to the

political leadership. Besides, not all resource abundant countries such as Botswana have developed predatory, factional or become rentier state on scale that has been achieved in a country like Kenya which has not even been categorised as a mineral producing country. You can now imagine what will happen to the country when it joins the league of oil producing countries. We cannot also say that all resource abundant countries have suffered from the same level of corruption and rent-seeking to the same extent as resource poor countries, Botswana being the obvious exception to this general pattern (Acemoglu et al 2003). In fact there is no guarantee that the current government will distribute some portion of resource windfall to alleviate the suffering of the Turkana communities.

Effert et.al (2003) have underscored the importance of regime types by arguing that democratic countries, particularly the mature ones have performed better. In our view, it is not that they have done better in terms of managing oil rents, exercising higher levels of transparency and accountability, tolerating corruption, and having capacity and more stable economic policies as exemplified by Norway, which had developed a solid economic base in terms of basic infrastructure and high standard of living. The East Asian countries which, by emulating the seven virtues embodied in the seven global pillars of: pragmatism, rule of law, culture of peace, meritocracy, market economy, education and science and technology had made a serious breakthrough (Mahbubani, 2008). In Africa, the rulers had instead, scaled down their vision and engaged in the instigation of tribal and ethnic conflicts, and constructed institutions of extraction that give them the full control over the revenues generated by natural resources exploitation. This is what constitutes the "curse", and not the natural resource per se. In examining the relationship between natural resource wealth, moderating political variables and development outcomes, a general tendency rather than iron laws begun to emerge (Rosser, 2006).

Using resource poor countries' experience such as Kenya, will tell us little that is of value, but would either lead us down the path of finding ways to prevent the

would be resource rich countries, from accessing their own resource wealth or engaging e in useless trips that only promote resource theft by those who currently exploit and plunder Africa's resources. In Kenya the intense political contestation over the compensation of political power and economic patronage has influenced the calculation of the political elites and propelled them to create greater mistrust that only escalates tension. As this happens, the government has adopted the "law of holes" by digging itself deeper into chaos to justify the plunder of resources, instead of digging itself out by stopping to dig.

6.7. The Way Forward

The book published in 1975, *Minerals in African Underdevelopment: A study in the continuing Exploitation of African Resources* (Ochola, Samuel O. 1975), recommended that since Africa had not built the requisite capacity and capability to meaningfully utilize its mineral resources in a manner that would ensure sustainable development, it would therefore be prudent to keep these resources   underground until such time that the requisite capacities and capabilities to use them profitably would have been built. Because once they are extracted they cannot be returned back to their original underground home from where they had been removed. Africa would be left the poorer. Roger Moody in his book "*Rocks and Hard Places: The Globalization of Mining" written over thirty years later* --also came to the same conclusion that; "Leaving the raw materials in the ground may prove the only way that many lesser –developing states can retain their diversities of real wealth, while there remains the option to resume mining at a later stage" (Moody, 2007 p.10).

If the resources are left in the ground, economic principles suggest that their expected return will be competitive with the return of foreign investments. Furthermore, leaving resources in the ground can also reduce the risk of their misappropriation and quick depletion by government allocating resources to finance consumption for political ends or by diverting billions of dollars into the secret accounts of African leaders rather than being re-invested in domestic assets to stimulate economic activities in other parts of the economy. While the

costs of any deferred development strategy maybe unpopular and cause delay in the diversification of the economy, but such diversification would eventually be achieved by the extraction and the conversion of resource wealth into broader portfolios of other assets, and rather than using the resources to mortgage the country's future oil income in exchange for expensive loans.

The views of the these authors, of leaving mineral resources underground are ground in the belief and based on the assumption that the exploitation of the natural resource riches will lead to national socio-economic prosperity, only when this wealth remains in Africa. Yet up to now, the exploitation of these resources has yielded the exact opposite of what the people in the rich mineral developing countries had expected.

In particular, the African people who were hopeful that independence would bring to an end the colonial exploitation of the African natural resources and to usher in a new era of national control over their natural resources found these to be a hard nut to crack, as greater inequality and deeper poverty became the order of the day. But, as already witnessed, the utilization of African natural resources has left nothing but trails of widespread poverty and misery as transnational companies, developed countries, and the African governments have perfected ways to cheat in pursuing their own self interest to the detriment of the African people. All these point to the urgent need to build adequate and requisite capacity in terms of human-capital and institutions.

It is only recently that the government of Kenya has started to show interest in minerals as a source of wealth, following the discoveries of minerals such as titanium, gold, manganese, iron ore, chromite, uranium, hydrocarbon (oil), gas and geothermal energy. An attempt by the mining Cabinet Secretary to wade into these murky waters only revealed the complete lack of understanding and knowledge on the part of the government of what needs to be done within this natural resource sector. First, it was not just the withdrawing of the licenses that was important, but it was the need to have a complete review of the past mining

legislations and concessions. Second, the issue of mineral development is not just a legal It issue. It is also a development issue. And so in drawing up a new legal framework to manage their utilization, all efforts must be made to involve all the disciplines and all the stakeholders, and not only lawyers as demonstrated by the Cabinet Secretary when he appointed a team of lawyers to review the licences and to formulate a new mining legislation. Third, the reaction to the withdrawal of the licences indicated that the sector was operating under licensed corruption that facilitates free loot. Lastly, the unscrupulous mining companies could do whatever they liked because the country lacks the capacity to monitor what goes on in the mining sector, and the unwillingness of the government to tap and use its available experts in verifying what the foreign mining companies have been doing in the country in order to seal the loopholes.

The development of mining industry in the country is not just signing or exchanging of memoranda, but should involve the drawing up training programmes for the development of manpower in all areas of mining disciplines using the already existing world class mining institutions worldwide. Indeed, a country cannot meaningfully participate in the development of minerals unless it has developed the necessary skills in this area that would enable it to use the latest technology, including remote sensing and other latest techniques in this area. At present, African countries in general and Kenya in particular, remain poorly surveyed and suffers from the paucity of information about its mineral resource potential.

It is interesting to note the recent statement by the World Bank that it was going to put aside US$1 billion to help map out Africa's resources! This is an insult when in 1978, Economic Commission for Africa (ECA), through the Chief of the Division of Natural Resources, Professor David Wasawo called for the establishment of African key institutions to do what the World Bank is calling for now. It is only possible for the country to extract better terms in its negotiations with its partners or transnational corporations and enter into equitable deals, if it has at its fingertips a comprehensive knowledge of resources, a complete

geological database and an inventory of its mineral resources should it need to do so. Otherwise it will be negotiating as an ignorant and blind person, relying on the information that the party it enters into negotiation with avails to it. This one way track in which one partner knows more than the other cannot be called negotiations. From this stage, the country should go the whole way to develop the required manpower for the exploitation of its mineral resources. To summarize, a country must have;

- adequate information and knowledge of its mineral resources,

- carried out a comprehensive and a complete geological surveys of all its natural resources,

- complete geological database and an inventory on the types of minerals available , their locations, quantities and qualities,

- developed technological capacity in mineral processing and development.

Unless all these requirements have been met, it would be futile even to hold discussion or negotiate with the would be investors, because the country would be in a very weak position, and make a fool of itself. It is the lack of knowledge of what we have and the capacity to transform our economies that has made us to be stuck to the export of raw materials. The raw material "export mania" that has instituted the one-dimensional method of exploiting and utilizing the natural resources in Africa has forced our economies to remain enclaves even during post colonial period, and whose only link with the rest of the economy is through the taxes that are being paid to the state by the mining companies and through the cadre of a small pool of low level and unskilled African workers. So when Kenya's Cabinet Secretary of mining was being interviewed for the post, and all those who were interviewing could think of was in terms of how the country could benefit from its huge mineral potential, was how the country could earn its foreign exchange from exports of these resources, royalties and tax receipts,

and nothing else beyond this! Our inability to escape from the export dungeon could not permit the Cabinet Secretary himself to think outside the box and to talk on the need of the country's mineral resources to be used for industrial development. Further, the Cabinet Secretary was completely unaware that in 2009, the Africans Head of State and Governments had adopted the African Mining Vision (AMV) which sought to shift the utilization of mineral beyond extraction of mineral and the sharing of revenue, but also to use the minerals for the structural transformation of the African economies. Based on the abundance of its natural resources and minerals, the Heads of States and Governments reaffirmed that Africa's industrialization should be anchored on the utilization of its minerals and other natural resources for achieving the Millennium Development Goals (MDGs) of eradicating poverty and achieving sustainable growth and economic development of the continent (ECA and AU, 2011). The details of the Africa Mining Vision are summarized in Box 6.4 below.

Box 6.4: African Mining Vision

A knowledge driven African mining sector that catalyses and contributes to the broad –based growth and development of, and is fully integrated into a single African market through:

Downstream linkages into mineral beneficiation and manufacturing;

Upstream linkages into mining capital goods, consumables and service industries;

Side-stream linkages into infrastructure (power, logistics; water) and skills and technology development (HRD and R&D);

Mutually beneficial partnerships between the state, the private sector, civil society, local communities and other stakeholders; and

A comprehensive knowledge of its mineral endowment

A sustainable and well-governed mining sector that effectively garners and deploys resource rents and that is safe, healthy, gender and ethnicity inclusive,

environmentally friendly, socially responsible and appreciated by surrounding communities.

A mining sector that has become a key component of a diversified, vibrant and globally competitive industrializing African economy.

A mining sector that has helped establish a competitive African infrastructure platform, through the maximization of its propulsive local and regional economic linkages.

A mining sector that optimizes and husbands Africa's finite mineral resource endowments and that is diversified, incorporating both high value metals and lower value industrial minerals both at commercial and small-scale levels;

A mining sector that harnesses the potential of artisanal and small-scale mining to stimulate local/national entrepreneurship, improve livelihoods and advance integrated rural social and economic development; and

A mining sector that is a major player in vibrant and competitive national, continental and international capital and commodity markets.

Source: AU-UNECA, 2009

A central premise of the AMV is that the mining operations in Africa should not and need not be activities of an enclave. And while acknowledging the need to overcome the governance challenges that would enable Africa's minerals to contribute to sustainable development and proposing that the existing natural resources laws and regulations be reviewed to better accommodate the interests of African countries, we are still of the opinion that the critical missing links in all these arguments which perhaps would render the achievements of these objectives untenable is the paucity of intellectual capital and institutional capacity, that would enable African countries to fully harvest the benefits of its huge oil minerals and other natural resources wealth.

We are more than convinced that the regulatory and legal instruments that maybe put in place will only help the countries to slow down the rate of the present plunder of the African natural resources, but will not fundamentally transform the structural nature of our socio-economic development. It is against this background that we would strongly argue that, unless a country is able to compute and weigh the long-term socio-cultural and ecological consequences of mining, against the gains from rents and other derived incomes, it would still be wise and prudent to leave these resources underground until such a time that we are able to ensure that the exploitation and enjoyment in the utilization of these resources will not compromise and jeopardise the interests of future generations to do the same.

We would therefore do well to take measures that would protect our mineral wealth, even if it means leaving them underground for the moment while we build the capacity and the infrastructure that will enable us to subsequently extract and utilize these resources for the good of the current and future generations. This measure will also limit the rate of resource depletion. The doubting Thomases may not agree but our considered view make us give this as a bankable proposal worth consideration.

Second, we would strongly support the formulation of new mineral laws, whose preparation would involve the participation of all the key stakeholders. The new mineral law that should include in one of its provisions, a requirement that no minerals or other natural resources will be exported from the country unless they have undergone value-addition processes. The implementation of such a provision will force the African countries to build the capacity and capability to properly utilize their minerals and other natural resources, and to forestall the unnecessary depletion and exploitation of Africa's natural resources.

Lastly, the issues on the sharing of resources must be revisited with a view to showing that the country is ready to exploit its resources in a manner that would add value to its own economic development and not to continue to rely only on

rents to be derived from mineral extraction. Therefore, the involvement of the World Bank and the IMF in assisting African countries in drawing up any new mining legislation, would also need to be reviewed as there is an urgent need to redirect the exploitation and utilization of Africa's mineral resources away from the same old trodden path that had entrenched obeisance to the interests of the big mining companies and that of their home countries and guaranteed the delivery of Africa's mineral resources on a silver platter to those exploiting these resources.

 Furthermore, we need to revisit all the current contracts and renegotiate them afresh using well known best examples (practices).We need not belabour the point that profits derived from mineral exploitation in Africa are always siphoned off to the global world capitals. Indeed, for the purposes of bargaining with the rest of the world, it would be prudent to establish standard legislation at a continental level so as to protect individual countries. It will also help the continent to eliminate the secretive and opaque contracts that some developed countries have signed with African countries.

Unless we are able to do what have been proposed in this study, the authors are more inclined to propose what Samuel Ochola proposed in 1975, that "we leave our minerals underground until such a time that we are able to exploit them in a more sustainable way". We shall even be richer because nobody would have removed these minerals away. We shall be able to use these minerals at a later stage when we will have built the capacity which we can do within the next 10 years to enable us utilize these resources in a more sustainable manner. This in our view is the only way forward.

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CHAPTER 7

Elimination of tariffs under WTO NAMA negotiations and the EAC-EU Economic Partnership Agreements

Lucia Mary Mbithi

7.1. Introduction

Economic Partnership Agreements (EPA) are reciprocal preferential trading arrangements being negotiated between the EU and different ACP groups of Countries. Negotiations on EPAs between the various groups of ACP groups of countries and European Union (EU) started in 2002. In Africa, EU has been negotiating such agreements with four Regional Trading Arrangements, EAC being one of these RTAs. EPAs involve elimination of tariffs on reciprocal by the ACP group of countries and the EU. The general objectives of the Economic Partnership Agreements (EPAs) are to contribute to economic growth and development; promote regional integration, economic cooperation and good governance; promote the gradual integration of ACP countries into the world economy; among other objectives.

Progress in EPA negotiations has seen the EAC, among other ACP group of countries initial a framework agreement (EAC-EU Framework Economic Partnership Agreement- FEPA) in 2008, which provides for the two regions cooperation in trade in goods. The two regions are still negotiating a comprehensive EPA agreement to include cooperation in services trade in addition to goods.

According to the EAC-EU framework agreement (EAC 2008), the objectives of EAC-EU cooperation in goods trade are:

i. The provision of full duty-free and quota-free market access conditions for goods originating in the EAC Partner States into the market of

the EC Party on a secure, long-term and predictable basis in accordance with the modalities established in this Agreement;

ii. The progressive and gradual liberalisation of goods market in the EAC in accordance with the modalities established in the FEPA; and

iii. Preservation and improvement of market access conditions to ensure that EAC Partner States are better and not worse off.

Thus the current EAC-EU FEPA, which is currently governing trading between EAC Partner State countries and the EU, seeks to eliminate tariffs between the two regional trading arrangements on preferential basis, with an objective of forming an EAC-EU FTA. Elimination of duties on products exported from the EAC Partner State countries into the EC market is immediate after the agreement comes into force. Since 2009, all EAC Partner State countries exports to the EU are on duty free basis.

In the framework agreement, EAC liberalization of her imports from the EU is to be progressive, starting two years after the EAC- EU EPA has come into effect and with import duty being targeted for elimination within a period of seventeen years, and the EAC- EU EPA comes into effect. The liberalization schedule (EAC, Secretariat, 2008) is presented below:

i. For all goods (both agricultural and manufactured) for which EAC CET rate is 0% (raw materials), elimination is to be achieved two years after the entry into force of the agreement. The MFN rate for these goods is 0%, and therefore 'abolishment' mentioned in the agreement will mainly be a commitment under the EPA agreement.

ii. For goods which currently EAC is charging import duty in line with the EAC CET (10 and 25%), abolishment of the current tariffs is progressive and is based on the schedule presented below:

- Seven years after the entry into force of this agreement each duty shall be reduced to 80 % of the basic duty,

- Eight years after the entry into force of this agreement each duty shall be reduced to 70 % of the basic duty,

- Nine years after the entry into force of this agreement each duty shall be reduced to 60 % of the basic duty,

- Ten years after the entry into force of this agreement each duty shall be reduced to 50 % of the basic duty,

- Eleven years after the entry into force of this agreement each duty shall be reduced to 40 % of the basic duty,

- Twelve years after the entry into force of this agreement each duty shall be reduced to 30 % of the basic duty,

- Thirteen years after the entry into force of this agreement each duty shall be reduced to 20 % of the basic duty,

- Fourteen years after the entry into force of this agreement each duty shall be reduced to 10 % of the basic duty,

- Fifteen years after the entry into force of the agreement the remaining duties,

- Sixteen years after the entry into force of this agreement each duty shall be reduced to 70 % of the basic duty,

- Seventeen years after the entry into force of this agreement each duty shall be reduced to 65 % of the basic duty.

7.1.1. WTO Non Agricultural Market Access (NAMA) negotiations and EAC

The WTO Non -Agricultural Market Access (NAMA) negotiations under the Doha Development Agenda (DDA) initiated in 2001, aim to reduce or as appropriate eliminate tariffs, including the reduction or elimination of tariff peaks, high tariffs, and tariff escalation, as well as non-tariff barriers (WTO, 2001).

During the Hong Kong Ministerial Conference (WTO, 2005), a Swiss formula was adopted as the approach for tariff cuts in the NAMA negotiations by developed countries and some developing countries. LDCs are exempted from use of the formula but are encouraged to increase their tariff binding coverage. As a part

of the Special and Differential Treatment (S&DT), the developing countries with a tariff binding coverage of less than 35% of their non- agricultural products tariff lines are exempt from formula reductions, but are instead required to bind 75 to 80 percent of their industrial goods tariff lines at an average level that does not exceed 30 percent (WTO, 2008).

With the current proposals of tariffs negotiation at the WTO, the five EAC Partner State countries do not have to reduce their tariffs, although Kenya is expected to make commitments to bind 75% of her tariff lines at an average rate not exceeding 30%.

7.1.2. EAC industrial sector

The contribution of the manufacturing sector to the EAC Partner States economic production remains low, being over 10% of the GDP only in Burundi and Kenya. Contribution to merchandise exports is significant, being over 20% for Kenya, Tanzania and Uganda and imports form the largest share of merchandise imports in the region.

Table 7.41 shows the EAC countries industrial goods import source markets in 2010. United Arab Emirates was the leading import source market in 2010 followed by China. Put together, EU member countries are also an important source markets for EAC manufactured goods imports. Kenya is among the top ten import source markets of manufactured goods by the other EAC Partner State countries.

Table 7.41: EAC industrial goods source markets (2010)

Partner Name	Average	Max Rate	Imports Value in 1000 USD	Share (%)	Dutiable (%)
United Arab Emirates	14.11	55	2356396.7	11.9	57.5
India	11.18	55	2271477.3	11.5	52.7
China	13.51	55	2129064.9	10.8	57.0
South Africa	12.67	55	1542083.2	7.8	47.5
Japan	12.49	55	1336521.3	6.8	75.8
Kenya	0	0	937808.2	4.7	0.0
United Kingdom	12.08	55	790470.8	4.0	53.5

United States	12.54	55	699646.6	3.5	27.0
Saudi Arabia	14.22	45	607654.1	3.1	63.6
Germany	10.89	55	606147.2	3.1	45.9
All countries	11.5	55	19767655.9	100.0	48.1

Source: TRAINS, 2012

Tariffs applicable to EAC Partner State imports of various manufactures are in line with those of the East African Community (EAC) Common External Tariffs (CET). These are categorized in three broad bands of raw materials, intermediate and finished goods with rates of tariffs being 0 percent, 10 percent and 25 percent respectively. Products considered as sensitive in the EAC region face applied tariffs much above those of the finished goods. Under the EAC Tax remission scheme, some products upon request by specific EAC countries, considered an inputs in manufacturing are imported on zero duty rate. The main export destination markets for EAC industrial goods include EAC itself, European Union (EU) and USA.

7.1.3. Concerns with the EAC- EU EPA

Apart from the EAC countries themselves, EU is the largest developed export destination market for EAC industrial goods accounting for about 17% of the export market share. It is also among the largest import source market.

Under the current WTO NAMA negotiations, EU will be expected to reduce her tariffs in line with the current NAMA negotiations proposals on a multilateral basis. Under the EAC-EU EPA Framework Agreement (FEPA), EU has made commitments to eliminate her tariffs for EAC member countries on preferential basis. Most of manufactured products exports by the EAC countries into the EU are either on duty free or face low duty rates. None of the EAC countries are expected to reduce their tariffs on industrial goods under the ongoing WTO DDA, but the countries will have to eliminate their tariffs on industrial goods for goods imported into the region from the EU.

What is the effect of EU reducing industrial goods tariffs on multilateral bases on EAC Partner States trade in industrial goods which are already being traded on duty-free bases under the EAC-EU EPA trading arrangement? What are manufacturing products trade flow and welfare implication of EAC Partner State countries eliminating tariffs under the EAC-EU EPA trade regime?

In this chapter, we analyse the importance of the EAC-EU EPA industrial goods tariff liberalization, in the face of multilateral tariff liberalization under the WTO NAMA negotiations. More specifically, this chapter analyses the:

i. Trade flow impact of tariff reduction by EAC countries on EU industrial goods imports into the EAC,

ii. Impacts of EU liberalization on preferential basis (under EAC-EU EPA) on EAC industrial exports to the EU,

iii. Impacts of EU elimination of tariffs on MFN basis on EAC industrial goods exports to the EU market and,

iv. Welfare implications of the EAC industrial goods liberalization under the proposed EAC-EU EPA trading regime on the EAC countries.

Our findings are useful to EAC Partner States policy makers especially during the negotiations for the comprehensive EAC- EU EPA. The findings will inform decision makers on the specific sectors where EAC Partner States will need to take actions to exploit any possible market access likely to arise from tariff reduction. In sectors where there is likely to be loss in trade, the decision makers will need to take measures towards increasing competitiveness of those industry sectors.

Researchers in EAC integration policy and development will also find this study useful as it will contribute to the currently scarce body of literature on EAC –EU EPAs and the multilateral tariff reduction at the global level.

7.2. Literature review

That free trade benefits all countries has been well documented starting with Smith (1776). Other authors including Gans et. al., (2011) and Krugman, Obstfeld and Melitz (2012), among other have recently shown that reduction in tariffs or free trade leads to lower prices in the importing country leading to an increase in consumer surplus while there is a decrease in producer surplus.

Several authors have shown that unilateral tariff reduction lead to welfare increase in an economy. Other studies have argued that, compared to preferential trade liberalization, multilateral liberalization is better because regional trade agreements may lead to diversion of trade away from the most efficient global producers to regional partners, therefore leading to loss in welfare (Bhagwati, 1993; Bhagwati and Panagariya 1999; and Bhagwati, 2008). In a multilateral liberalization however, not all the countries gain from tariff reductions because for every tariff reform, there are winners and losers (Gans et. al., 2012).

Effects of tariff elimination on preferential basis may not always lead to increased welfare. Viner (1950) showed that tariff reduction under preferential trading arrangement leads to ambiguous welfare effects, the net welfare effects being determined by the both trade creation and trade diversion.

Studies of RTA effects on trade flows have been mixed with studies showing that some RTAs show an evidence of trade diversion while others do not.

Clausing (2001) analysed the effects of an RTA by analysing the Canada-United States Free Trade Area (CUSFTA). He used regression analyses how tariff changes affect trade flows in this FTA. He used desegregated data utilizing the extent of liberalization across goods. His analysis found that CUSFTA had contributed to increased trade with more increase in trade in goods which experienced the largest tariff liberalization. His results did not show evidence of trade diversion.

Khorana, Kimbugwe and Perdikis (2007) assessed trade creation and trade diversion in Uganda as a result of EAC Customs Union (CU) using a partial equilibrium model SMART embedded in WITS data access. They estimated trade, welfare and revenue effects under the EAC CU and analysed the impact of tariff reductions on different product groups for Uganda. Their findings dispelled the fear of large trade imbalances in Uganda after full liberalization of the intra-EAC tariffs, thus questioning the rationale the country's advocacy of domestic protecting its domestic industry. Their analysis did not show adverse trade impact of the EAC CU on Uganda products.

A study on the impact of Doha (Zepeda, el,. Al, 2009), analysed the likely impact of the current Doha agreements (under negotiation), including reduction of subsidies by developed countries, and reduction of tariffs by both developed and developing countries, on Kenya. The study used the Computable General Equilibrium (CGE) model. A key finding of the study was that Kenya is likely to gain in agricultural products and processed foods but is likely to lose in the manufacturing and mining sectors. Secondary effects would contribute to increase of services output. On overall, the study found that liberalization of goods trade will lead to a slightly annual increase of Kenya GDP of 0.2 percent.

Karingi and Fekadu (2009) analysed the implications of forming the COMESA-EAC –SADC Tripartite free trade area. Their study found that the TFTA could confer benefits to the RTA members. The findings indicated that most benefits would be conferred to SADC region followed by EAC, then COMESA in that order. In a related study UNDP (2011) and Makochekanwa (2012) also found that the TFTA would lead to trade creation for the members including the EAC Partner States countries.

CEP II (2008) analysed the impact of the EU- ACP EPAs on various ACP groups negotiating an EPA with EU, using a partial equilibrium analysis model. The study found that although there were revenue loses likely to be experienced by each

EAC RTA negotiating an EPA, in general there would be minor effect on ACP domestic production due to EPAs because EU products are not in direct competition with ACP production.

IEA (2008) analysed the effect of MFN tariff reductions and elimination under the current WTO NAMA negotiations on the share of Kenya non agricultural exports and on the preference erosion that Kenya is likely to experience. The study used the SMART simulation model, and data from the UNCTAD's Trade Analysis and Information System (Trains). The analyses showed that, if MFN tariffs were to be eliminated in developed countries, Kenya is likely to experience loss in trade value due to preference erosion (loss in trade due to loss of preference margin) amounting to about US$ M 35, or about 6.6% of all Kenya Non-agricultural exports to the main developed countries' markets.

A few studies have been undertaken on trade creation and diversion effects of EAC trading arrangement, particularly the EAC Customs Unions. Studies have also been done on the effect of EAC-EU EPA on the regions welfare. Other studies have also been done on specific countries (particularly Kenya), analysing the effect of the current WTO negotiations on sectoral trade including the impact on the industrial goods trade.

Studies analysing the potential impact of the multilateral liberalization under the current WTO NAMA on the EAC-EU proposed EPA are currently missing, yet these two negotiations processes (EAC- EU EPA and WTO NAMA negotiations are both ongoing concurrently. This study aims at filling this information gap. The study will add value to the current body of literature on EAC RTA by providing the impact of the WTO NAMA negotiations outcomes on the EAC-EU FTA under the EPA.

7.3. Methodology

Reduction of tariffs leads to an increase in imports of relevant goods, raising domestic consumption and reducing domestic production. There is a gain in consumer surplus and loss in producer surplus due to reduced prices as tariffs are

reduced, and there is loss of the tariffs revenue. There is expected increase in welfare.

In the case of preferential tariff reduction, the welfare effect is ambiguous due to trade creation and diversion (Viner, 1950). Figure 7.7 shows the effects of trade creation and diversion in a country (country A) which forms a preferential trading arrangement (FTA) with country B. Initially, before the formation of the RTA, imports are equal to KL (difference between supply and demand in country before the RTA is formed).
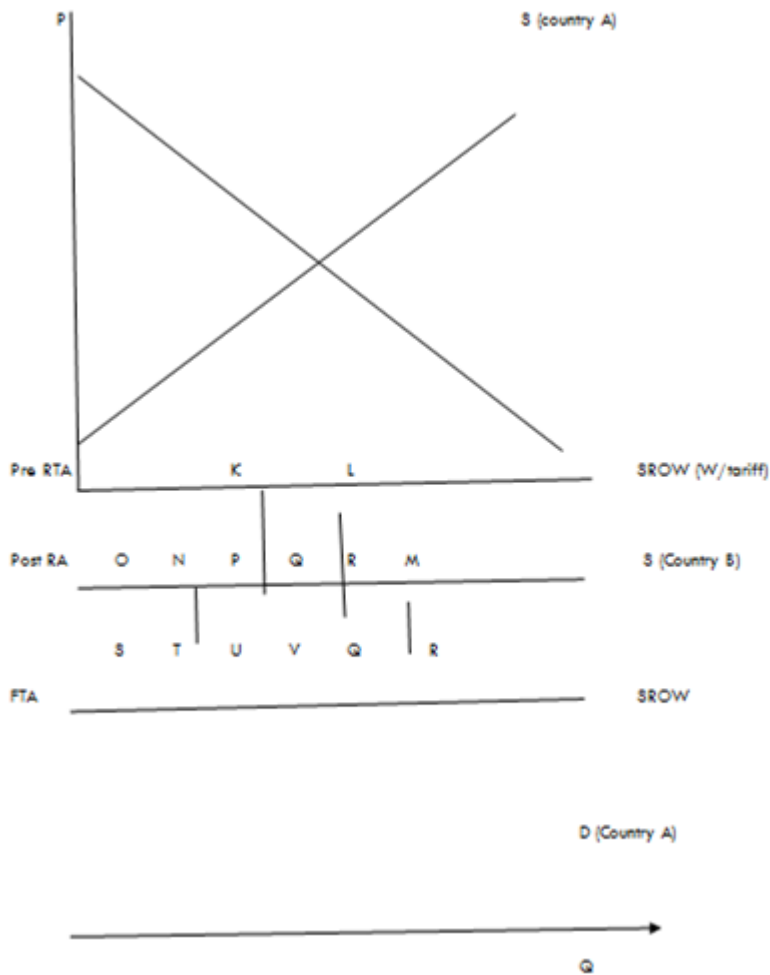
Figure 7.7 : Theoretical impacts of reducing a tariff

With the formation of an FTA, exports by country B become relatively more competitive than the goods from the ROW, because the FTA price is lower than the MFN tariff inclusive of world price faced by the ROW. The lower FTA price leads to an increase in demand in country A while production in the same country is reduced. Import quantities into country A are now higher at LM. Domestic consumers gain area OPQR while domestic consumers lose area O, and tariff revenue falls by QV, with the welfare effects being ambiguous. Trade creation

leads to a gain of areas PR, while trade diversion leads to a loss of area V. Trade diversion will occur as imports from country B will replace lower cost ROW imports. The real effect of the FTA will depend on the extent of trade creation and trade diversion.

In this analysis, we use the SMART model, an ex-ante partial equilibrium model embedded in World Integrated Trade Solution (WITS) data retrieval system. The model allows estimation of the impact of tariff reductions on bilateral, preferential or multilateral levels on trade flows, tariff revenue, and welfare. Details of the SMART model are presented by Laird and Yeats, 1986). Recently, the SMART model has been used to analyse the impacts of MFN tariff cuts on trade values by Yeats (1994), Jachia and Teljeur (1999), ECA (2006), IEA (2008) and Makochekanwa (2012).

The two main advantages of the partial equilibrium models are the minimal data requirement and provision of an analysis at a fairly disaggregated (or detailed) level. Data required in the above model include data on trade flows (exports and imports, the trade policy (specifically tariff), and supply and demand elasticities.

We analyse the impact of tariff reduction at the WTO by EU on EAC countries non- agricultural products exports to the EU. We assume a case of tariff elimination in this analysis.

In estimating the EAC- EU EPA preferential benefits, both EAC and EU member countries are assumed to eliminate their industrial goods tariffs on bilateral basis. In estimating the impact of the EU tariff elimination under the WTO trade regime, EU is assumed to eliminate her tariffs on multilateral basis. In addition to trade flow impacts, the welfare effects of EAC countries eliminating tariffs under the proposed EAC-EU EPA are also estimated.

7.3.1. Trade creation

Estimation of trade creation, trade diversion and welfare effects is based on Laid and Yeats (1986).

Trade creation provides an estimate of the increase in specific markets imports (either in the EAC or in EU) in relative prices of these imports in the relevant market (i.e. either EAC or EU) industrial products. This leads to a net increase in a specific market's total imports and a net decrease in the same market's domestic production. The main assumption in this case is that there is a full transmission of changes of both the preferential and multilateral MFN tariff reductions.

Trade creation (*TC*) for product *i* exported from country *k* to country *j* was estimated as:

$$TCijk = \frac{Mijk \times Em \times dtijk}{[(1+tijk) \times (\frac{Em}{Ex})]} \quad \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots..2$$

Where;

 M ijk is the import value of industrial good *i* by trading partner country *j*

 Em is the elasticity of import demand with respect to domestic price of the importing country,

 Ex is the elasticity of export supply with respect to export price of EAC Partner State country or EU.

 tijk is the tariff rate faced by an industrial product *i* when exported by country *j*.

 dtijk is the change in tariff rate faced by industrial product, *i* when exported *j*.

7.3.2. Trade diversion

Trade diversion is a measure of increase in the particular market's import of non agricultural products from either EAC Partner State country or EU due to decrease in relative prices of these products in relation to imports from the rest of the world. The imports to the particular market increase at the expense of the imports from the rest of the world without changes in total exports. The trade diversion (*TD*) caused by a non agricultural product *i* exported from EAC Partner State country or EU (*k*) to market *j* (either EAC partner State or EU) was estimated in the model as:

$$TDijk = TCijk \times [\frac{Mnij}{Vij}] \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots.3$$

Where:

> *TCij* is the trade creation by an industrial product (*i*) exported by EAC Partner State country or EU (*k*) to country *j*.

> *Mnij* is the imports by country *j* of industrial product *i* from non-preference-benefiting countries

> *Vij* is the output of non agricultural product *i* in the importing country *j*.

7.3.3. Estimation of elasticity of import demand

Elasticity of import demand ($\frac{dMijk}{Mijk}$) of the non agricultural product *i* exported from EAC Partner State country into export destination market *k* (assuming substitutability between EAC's country of non agricultural products and similar products from the rest of the world) was estimated in the model as:

$$\frac{dMijk}{Mijk} = Em[\frac{dtijk}{\{(1+tijk)+(\frac{dPijk}{Pikj})\}}] \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots.4$$

Where:

Em is the elasticity of import demand with respect to domestic price of the export destination market,

tijk is the tariff rate faced by product I in export market j when exported from EAC country,

dtijk is the Change in tariff rate is the tariff rate faced by product I in export market j when exported from EAC country,

Pikj is the- price of non agricultural product i from EAC country in export market j,

dPijk is the change in price of non agricultural product i from EAC country in export market j.

7.3.4. Estimation of elasticity of export supply

The model estimates the elasticity of export supply of non agricultural product *i* exported from EAC (*k*) or EU to market *j* (either EU or EAC, respectively) as shown in equation 4:

$$\frac{dMijk}{Mijk} = \frac{dXikj}{Xikj} \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots..4$$

Where;

Mijk is the imports of non agricultural product *i* from EAC or EU by *j* (EAC or EU),

dMijk is the change in imports of non agricultural product *i* from EAC Partner State country or EU by country *j* (EAC country or EU),

Xikj is the exports of non agricultural product *i* by *j* (by EAC or EU) to *k* (EU or EAC, respectively),

dXikj is the change in the exports of non agricultural product *i* by *j*(EAC or EU) to *k* (EU or EAC, respectively).

The effect of multilateral and preferential elimination of tariffs on total non agricultural products exports from each of the EAC Partner State country or EU to EU or EAC Partner State market was estimated as the sum of trade creation and trade diversion.

The importance of the EAC- EU EPA benefits on the EAC industrial sector in the face of multilateral liberalization is estimated as the differential between the trade flows under both the preferential and multilateral liberalization scenarios.

7.3.5. Assumptions of the Model and the elasticities

Three main assumptions were made with respect to elasticities in this analysis

iv. Export supply elasticities are infinite. This is because EAC Partner State economies are small economies by global economy standards. This is the price taker assumption.

v. Armington assumption on substitutability for export supply, which means that, exports of different countries, although similar, are imperfect substitutes.

vi. Import substitution elasticity of 1.5, implying that similar products from different countries are imperfect substitutes.

Data sets used in this study were obtained from the UNCTAD's Trade Analysis and Information System (Trains). Data used was for the year 2011 or any other

available latest year. The data were be accessed through the World Integrated Trade Solution (WITS).

Data used include: export and import values of industrial goods from each of the EAC Partner State countries to all countries of the World, export and import values of industrial goods from the EU to all the countries of the world; and respective tariffs, both MFN and preferential existing in the EAC Partner States countries and the EU.

7.4. Findings

7.4.1. Effects of EU multilateral liberalization on EAC exports to EU

Simulation results of partial equilibrium analysis on effects of EU eliminating tariffs at the multilateral level on the exports of EAC countries' to the EU market is shown in Table 7.42. Trade data used if for 2011.

Table 7.42: Change in exports of EAC countries to EU market if EU eliminates tariffs at multilateral level

Partner Name	Exports Before (US$ '000)	Exports After (US$ '000)	Export Change (US$ '000)	Trade Creation Effect (US$ '000)	Trade Diversion Effect (US$ '000)
Burundi	7236.921	7180.694	-56.227	0	-56.227
Kenya	264546	258887.2	-5658.88	0.665	-5659.54
Rwanda	9891.033	9842.09	-48.943	0	-48.943
Tanzania	334323.4	327455.9	-6867.54	0.496	-6868.03
Uganda	104152.6	99428.24	-4724.35	0	-4724.35
EAC	720150	702794	-17355.9	1.161	-17357.1

Source: TRAINS (2012)

If EU was to eliminate tariffs in 2011, the value of EAC exports to EU would reduce by some US$M 17.4, an equilvalent reduction of 2.4 percent of the total EAC exports to EU in 2011.

This suggests that if EU eliminates tariffs at the multilateral level, while simultaneously in FTA trading arrangement under the FEPA (and therefore

roposed EPA) trading regime, where EU grants free market access to EAC manufactured goods, the value of EAC countries' manufactured products exports to EU is likely to reduce by about 2.4 percent in the short run.

This therefore shows that the beneficial value of the EPA to EAC countries will reduce by about 2.4 percent if EU was to liberalize at the multilateral level. The reduction in EAC exports is due to trade diversion by manufactured goods exports to EU from other non EAC-EU FEPA (or EPA) trading partners who are probably more efficient and therefore more commpetitive in the EU market than EAC countries' manufactured goods exports. EAC manufatured products exported to EU most affected include fish and related products and textile related products. These products have the highest preference margin (MFN tariff and preferential tariff applicable to EAC manufactured products in the EAC market).

In the EAC region, only 2 products exported by Kenya and Tanzania may experience an increase in exports to EU as shown in Table 7.43. These are other parts and accessories of shotguns or rifles and other sporting, hunting or target-shooting rifles whose tariffs existing before EU elimination of tariffs is 2.7 and 3.2 percent, and do not enjoy duty free treatment in the EU market.

Table 7.43: EAC manufactured products likely to gain from increased market access on EU liberalization at multilateral level

Partner Name	Product Code	Product name	Trade Total Effect in '000 USD	Trade Creation Effect in '000 USD	Trade Diversion Effect in 1000 USD	Old Duty Rate (%)
Kenya	930330	Other sporting, hunting or target-shooting rifles	0.683	0.643	0.04	3.2
Tanzania	930330	Other sporting, hunting or target-shooting rifles	0.527	0.496	0.031	3.2
Kenya	930529	Other Parts and Accessories of Shotguns or Rifles	0.044	0.022	0.023	2.7
EAC, all manufactured products			1.254	1.161	0.094	3.03

Source: TRAINS (2012)

7.4.2. Implications of EAC countries liberalizing to EU under EPAs

Table 7.44 shows the results of partial equilibrium analyses results of the effect of EAC eliminating tariffs for manufactured goods imported from the EU.

If EAC eliminates the current applicable import duty for manufactured goods imported from the EU on preferential basis i.e. through the EPAs (Table 7.44), manufactured imports from the EU to the region are likely to increase by about 9 percent as shown in Table 7.44.

Table 7.44: Changes in EAC imports from the EU, if EAC countries eliminate tariffs (2011)

Country	EU imports into EAC		Trade Total Effect	Trade Creation Effect ('US $ 000)	Trade Diversion Effect ('US $ 000)	Old duty rate (%)	Increase in imports from EU (%)
	Before	**After**					
Burundi	94342.1	102841.7	8499.6	5745.9	2753.7	9.6	9
Kenya	2014582	2193955	179256.5	106162.2	73094.2	11.8	9
Rwanda	192538.1	213379.7	20841.6	13073.5	7768.1	9.8	11
Tanzania	1470906	1597497	126640.8	65283.9	61356.9	12.1	9
Uganda	609722.6	666631.6	56909.0	32370.5	24629.3	11.4	9
EAC	4382091	4774306	392147.5	222636.0	169602.2	10.9	9

Source: TRAINS Accessed through WITS (2012)

From Table 7.44, old duty rate shows the average import duty applicable on imports of manufactured goods from EU to the EAC Partner State country. Imports before and after shows the value of total imports from EU to a EAC Partner State country before and after liberalization under EPA simulations respectively. Table also shows the trade creation and trade diversion effect, with the two values providing the total trade effect.

In absolute terms, increase in imports from EU is likely to be higher in Kenya than in other EAC countries, which accounts for over 50 percent of the import increase. Increase in imports from EU is due to increased consumption of EU imports as price of these goods reduce due to elimination of import duty by Kenya market.

Tables 7.45 to 7.49 show the products likely to have the largest import increase into the EAC market. For all the EAC countries, these are products with higher tariffs of 25 or 10 percent in line with the EAC Common External Tariff (CET). Among these products are iron, steel, vehicles and vehicle spare parts, generally products which can be classified as high technology products.

Table 5: Products whose imports from EU are likely to increase more

Table 7.45: Most affected products in Burundi

Product Code	Product name	Trade Total Effect (US$' 000)	Trade Creation Effect (US$' 000)	Trade Diversion Effect (US$' 000)	Average duty rate before(%)
630491	Knitted or Crocheted, Other Furnishing Articles	782.9	605.54	177.4	12.5
391723	Tubes, Pipes, Hoses of Polymers of Vinyl Chloride (Rigid)	376.4	316.9	59.4	25
730799	Iron or Steel, Other Tube or Pipe Fittings	322.9	287.9	35.1	25
870899	Vehicles accessories and other parts	312.34	186.4	125.8	10
870332	Compression-ignition Engine (diesel) of a cylinder capacity exceeding 1,500 cc but not exceeding 2,500 cc, Other Vehicles	274.5	243.9	30. 5	12.5
850720	Lead-acid Accumulators, Other	216.4	175.7	40.7	25
730719	Cast Iron, Other Tube or Pipe	196.9	162.0	34.8	25

	Fittings				
620322	Cotton Men's or Boys' Ensembles	172.7	171..8	0.95	25
681091	Prefabricated structural components for building or civil engineering	151.3	128.6	22.8	25
482110	Printed labels of paper or paperboard	139.6	133.9	5.7	17.5
391729	Tubes, Pipes, Hoses of Polymers Plastics (Rigid), Other	136.3	58.4	77.9	25
870899	Parts & access for motor vehicles (head 8701-8705), Other	134.7	79.5	55.2	10
491110	Trade advertising material, commercial catalogs and the like	110.7	53.8	56.8	25

Source: TRAINS (2012)

Table 7.46: Most affected products in Kenya

Product Code	Product Name	Trade Total Effect (US$' 000)	Trade Creation effect (US$' 000)	Trade Diversion Effect (US$' 000)	Duty Rate before (US$' 000)
852352	Smart cards	5899.4	5406.0	493.4	10
870323	Spark-ignition Engine Of a cylinder capacity exceeding 1,500 cc but not exceeding 3,000 cc, Other Vehicles	4019.3	1685.8	2333.5	12.5
870323	Spark-ignition engine Of a cylinder capacity exceeding 1,500 cc but not exceeding 3,000 cc, Other Vehicles	3341.8	1398.0	1943.8	12.5
870332	Compression-ignition Engine (diesel) of a cylinder capacity exceeding 1,500 cc but not exceeding 2,500 cc, Other Vehicles	3058.9	2375.4	683.5	12.5
481092	Multi-ply	2992.9	2477.3	515.7	25
480257	Weighing 40 g/m² or more, Other	2868.4	1783.0	1085.4	25
853710	Bases for Electric Control or the Distribution, Not Exceeding 1,000v	2412.8	1751.3	661.5	10
480421	Unbleached kraft paper & paperboard, uncoat nesoi, rolls etc	2274.0	1688.0	586.0	25
480411	Unbleached kraft paper & paperboard, uncoat nesoi, rolls etc	2108.9	1163.4	945.5	25
381121	Additives for Lubricating Oils (Containing Petroleum Oils or Bituminous Oils)	2074.5	1575.1	499.4	10

Source: TRAINS (2012)

Table 7.47: Most affected products in Rwanda

Product Code	Product name	Trade Total Effect in 1000 USD	Trade Creation Effect in 1000 USD	Trade Diversion Effect in 1000 USD	Old Simple Duty Rate
854420	Co-axial Cable and Other Co-axial Conductors	1514.4	578.0	936.4	25
761490	Aluminium Stranded Wire, Cables, Plaited Bands and the Like, Other	1341.9	1339.0	2.9	10
852352	Smart cards	695.03	602.4	92.6	10

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Product Code	Product name				
870332	Compression-ignition Engine (diesel) Of a cylinder capacity exceeding 1,500 cc but not exceeding 2,500 cc, Other Vehicles	686.5	587.7	98.8	12.5
870323	Spark-ignition Engine Of a cylinder capacity exceeding 1,500 cc but not exceeding 3,000 cc, Other Vehicles	494.3	228.4	265.9	12.5
854420	Co-axial Cable and Other Co-axial Conductors	442.4	160.8	281.6	25
721491	Rectangular (other than square) cros	439.4	437. 7	1.922	10
870332	Compression-ignition Engine (diesel) Of a cylinder capacity exceeding 1,500 cc but not exceeding 2,500 cc, Other Vehicles	404.0	345.5	58.554	12.5
851770	Elec apparatus for line telephony, telephone sets, Parts	398.78	163.0	235.762	10
731300	Iron or steel twisted hoop or single flat wire, barbed or not, and loosely twisted double wire, Barbed wire of fencing, iron or steel	335.6	329.8	5.867	25

Source: TRAINS (2012)

Table 7.48: Most affected products in Tanzania

Product Code	Product name	Trade Total Effect (US$' 000)	Trade Creation Effect (US$' 000)	Trade Diversion Effect (US$' 000)	Duty Rate before (%)
300490	Minced: Surim, Alaska pollock (Theragra chalcogramma), Other	7838.5	3582.5	4255.9	10
481910	Cartons, boxes and cases, of corrugated paper or paperboard:	4028.6	3127.4	901.2	25
870323	Spark-ignition Engine Of a cylinder capacity exceeding 1,500 cc but not exceeding 3,000 cc, Other Vehicles,	2545.8	1054.0	1491.8	12.5
843149	Parts of Derricks, Cranes, Graders, Levellers, Scrapers or Pile-drivers	2542.8	1205.6	1337.1	10

401120	New Pneumatic Tyres of Rubber, of a Kind Used On Buses or Lorries	2306.8	906.7	1400.1	17.5
870333	Compression-ignition Engine (diesel) Of a cylinder capacity exceeding 2,500 cc, Other Vehicles	2221.6	946.1	1275.6	12.5
330210	Mixtures of Odoriferous Substances for Food or Drink Industries	1754.9	804.3	950.7	10
870421	Motor vehicles for the transport of goods GVW not exceeding 5 metric tons	1581.9	645.4	936.5	12.5
350691	Adhesives Based On Rubber or Plastics (Including Pratificial Resins)	1436.3	1411.8	24.6	25
851770	Elec apparatus for line telephony, telephone sets, Parts	1302.8	639.9	662.8	10

Source: *TRAINS (2012)*

Table 7.49: Most affected products in Uganda

Product Code	Product name	Trade Total Effect (US$' 000)	Trade Creation Effect (US$' 000)	Trade Diversion Effect (US$' 000)	Duty Rate before (%)
730890	Iron or steel structures and parts, there off	2756.5	1274.3	1482.2	25
480411	Unbleached kraft paper & paperboard, uncoat nesoi, rolls etc	2079.1	1503.7	575.3	25
852352	Smart cards	1962.8	1647.5	315.4	10
870323	Spark-ignition Engine Of a cylinder capacity exceeding 1,500 cc but not exceeding 3,000 cc, Other Vehicles	1511.2	576. 6	934.6	12.5
730890	Iron or Steel Structures and Parts, Other	1407.0	638.0	768.9	25
721420	Concrete reinforcing bars and rods, Hot-rolled, Hot-drawn, Hot-extruded	1393.8	1032.9	360.9	10
330210	Mixtures of Odoriferous Substances for Food or Drink Industries	1263.4	624.6	638.7	10
350691	Adhesives Based On Rubber or Plastics (Including Pratificial Resins)	920.6	903.2	17.4	25
690890	Glazed Ceramic Flags	835.1	425.8	409.2	25
490700	Unused postage, revenue or similar stamps of current or new	824.3	804.2	20.1	5

Partner Name	issue in the country to which they are destined; stamp-impressed paper; banknotes; check			

The increase in imports is due to both trade creation and trade diversion, with most of the increase (about 57 percent) being a result of trade creation effect.

Trade diversion is from both regional trading partner countries including those in COMESA and EAC and non regional trading Partner State countries. For Burundi, regional countries that are likely to experience large trade diversions include Kenya, Uganda and Egypt. Manufactured products exports from these countries face applied tariffs of zero as they are a part of the EAC Customs Union and COMESA FTA respectively. South Africa exports to Burundi also lose out. China imports into Burundi are likely to experience the largest lose (Table 7.50 7.54).

Table 7.50: Countries likely to face large trade diversion in Burundi market

Partner Name	TradeTotal Effect (US$' 000)	Trade Diversion Effect (US$' 000)	Average applied duty rate (%)
China	-539.337	-539.3	16.1
Japan	-436.2	-436.2	9.6
United Arab Emirates	-421.575	-421.6	15.6
Kenya	-320.419	-320.4	0
Uganda	-143.43	-143.43	0
Egypt, Arab Rep.	-64.128	-64.128	0
South Africa	-62.253	-62.253	13.1
Switzerland	-59.693	-59.693	16.66

In Kenya market China imports are likely to be the largest losers followed by imports from Japan. Imports from South Africa, Egypt and Tanzania also lose out in the Kenya market as shown in Table 7.51. Egypt and Tanzania trade with Kenya under COMESA and EAC Customs Union trading regimes, respectively.

Table 7.51: Countries likely to face large trade diversion in Kenya market

Partner Name	Trade total effect (US$, 000)	Trade diversion effect (US$, 000)	Average applied duty rate (%)
China	-18380.4	-18380.4	12.4
Japan	-11158.6	-11158.6	11.9
India	-8450.6	-8450.6	11.1
South Africa	-8101.3	-8101.3	12.1
United States	-4598	-4598	12.4
United Arab Emirates	-2961	-2961	13.4
Egypt, Arab Rep.	-2909.5	-2909.5	0
Thailand	-1651.2	-1651.2	15.4
Tanzania	-1638	-1638	0
Japan	-1445.14	-1445.14	12.5
Korea, Rep.	-1184.1	-1184.1	11.9

Source: TRAINS (2012)

In Rwanda market, China is likely to be the largest loser through trade diversion, followed by Tunisia and Japan. Kenya and Uganda, both members of EAC Customs union are also among the top ten largest losers in terms of trade diversion (Table 7.52).

Table 7.52: Countries likely to face large trade diversion in Rwanda market

Partner Name	Tradetotal effect (US$, 000)	Trade diversion effect (US$, 000)	Average applied duty rate (%)
China	-1728.8	-1728.8	14.3
Tunisia	-842.2	-842.2	10.2
Japan	-829.4	-829.4	11.6
Kenya	-760.1	-760.1	0.0
United Arab Emirates	-751.8	-751.8	15.2
India	-382.1	-382.1	11.3
Uganda	-356.9	-356.9	0.0
Hong Kong, China	-311.9	-311.9	13.7
Japan	-301.0	-301.0	12.5

Source: TRAINS (2012)

The largest losers in Uganda market through trade diversion are India and China. Other regional large losers include South Africa, Kenya and Tanzania (Table 7.53).

Table 7.53: Countries likely to face large trade diversion in Uganda market

PartnerName	TradeTotal Effect (US$, 000)	Trade Diversion Effect (US$, 000)	Average applied duty rate (%)
India	-4957.15	-4957.15	10.53
China	-3890.1	-3890.1	13.47
South Africa	-2853.12	-2853.12	12.67
Japan	-2462.94	-2462.94	12.41
United Arab Emirates	-2391.86	-2391.86	14.13
Kenya	-2121.74	-2121.74	0
United States	-938.544	-938.544	13.12
Swaziland	-474.31	-474.31	16.08
Singapore	-469.955	-469.955	14.14
Turkey	-431.317	-431.317	15.7
Tanzania	-430.502	-430.502	0

Source: TRAINS (2012)

For Tanzania, Kenya and South Africa are the largest regional losers, with China and India being the largest non regional losers as shown by Table 7.54.

Table 7.54: Countries likely to face large trade diversion in Tanzania market

Country	TradeTotal Effect (US$, 000)	Trade diversion effect (US$, 000)	Average applied duty rate (%)
China	-13896	-13896	12.7
South Africa	-10855	-10855	12.4
India	-6480	-6480	11.91
United Arab Emirates	-5961.1	-5961.1	12.9
Japan	-5148.2	-5148.2	12.8
Kenya	-3938.7	-3938.7	0
United States	-3096.1	-3096.1	12.9
Singapore	-1525.2	-1525.2	12.3
Australia	-1272.7	-1272.7	12.5
Swaziland	-1024.2	-1024.2	14.5

Source: TRAINS (2012)

7.4.3. Welfare implications of EAC countries liberalizing to EU under EPAs

On overall, preferential liberalization of EAC Partner State countries under EPAs is likely to make EAC Partner States better off on average as shown in Table 7.55. As a result of increased consumption and increased consumer surplus, welfare of EAC Partner State countries is likely to increase by over US$ M 25 (about 0.03 percent of EAC GDP). The welfare gain is as a result of possible fall in price expected to accompany elimination of import duty on imports from the EU market.

Table 7.55: Welfare effects of EAC liberalizing under EPAs

EAC Partner State	Trade Total Effect (US$' 000)	Welfare (US$'000)	Old weighted duty rate (%)
Burundi	5745.9	571.6	9.2
Kenya	106254.5	12602.2	11.0
Rwanda	13073.5	1391.5	8.8
Tanzania	65283.9	7607.4	10.9
Uganda	32370.4	3808.9	9.9
EAC	**222728.3**	**25981.6**	**9.9**

Source: TRAINS (2012)

Of the EAC five countries, Kenya is likely to experience the largest gains in welfare, accounting for over 50 percent of the regions welfare gain.

Although EAC is likely to experience welfare gains from liberalizing trade in manufactured goods under EPAs, the increased imports from EU may have a negative impact on the development and transformation of the much needed manufacturing sector in the region as it is likely to reduce producer surplus (manufacturers' gains). The manufacturing sector in EAC remains far less developed and less competitive as compared to the EU manufacturing.

7.5. Summary, Conclusions and Recommendations

Analysis of the impact of EU MFN tariff elimination at the multilateral level under the current preferential trade regime under EU EAC FEPA (and therefore the proposed EPAs) is likely to lead to a reduction in EAC exports to EU by about 9

percent. Exports of manufactured goods from EAC to EU are likely to be replaced by exports from other countries, which are not in a preferential trading arrangement with EU and who are more competitive compared to EAC countries.

Analysis of the impact of EAC eliminating tariffs for manufactured goods imported from the EU market shows that manufactured products imports from the EU to the EAC region are likely to increase by about 9 percent. Over 50 percent of increase in imports is due to trade creation as EU products obtain increased market access as a result of tariff elimination by EAC Partner State countries. Trade diversion exists with trade being diverted from regional trading partners with preferential trading arrangements with EAC Partner State countries including EAC countries themselves, Egypt and South Africa. The largest trade diversion is likely to be experienced by china.

Elimination of tariffs by EAC countries on manufactured imports from the EU is likely to lead to an improvement in welfare of EAC countries, due to likely increase in consumption as a result of a possible decrease in price as a result of elimination of tariffs.

Several conclusions can be drawn from the findings of this study:

Elimination of tariffs by EU at multilateral level will reduce the EAC – EU preferential trading arrangements benefits value through reduction of EAC manufactured goods exports to the EU. With multilateral liberalization by EU, EAC exports to EU are likely to be replaced by more efficient and competitive exporters.

If EAC countries eliminate tariffs on manufactured products imports from EU, imports from EU are likely to increase, replacing exports from other EAC Partner State countries, among other countries. Exports from china are likely to be the most affected. Regional partners most affected by increased imports from EU to the EAC market are Kenya, Tanzania, Egypt and South Africa.

Elimination of tariffs by EAC Partner State countries on manufactured products from EU is likely to lead to welfare gain due to a likely increased consumption as a result of reduction in prices due to tariff elimination.

7.5.1. Recommendations

Multilateral trade liberalizations will reduce benefits available to EAC countries under the EAC-EU trading arrangement.

Liberalization by EAC Partner State countries will lead to increased exports of manufactured goods to EAC by EU, which may depress the much aspired and needed development and transformation of the region's manufacturing sector as an engine of growth. For EAC countries to mitigate possible negative effects from multilateral liberalization by EU and EAC liberalization to EU imports, EAC countries need to take measures to increase competitiveness of their manufactured products and exploit their comparative advantage to enable them compete better in the EU market as well as in the region. Competitiveness is a function of a set of institutions, policies and factors that determine the level of productivity of a country (WEF, 2013), and EAC manufacturing sector is less competitive by global standards.

Among some of the measures EAC Partner State countries needs to take to improve competitiveness of their manufactured products include:

- Diversifying export basket to the EU market beyond fisheries products and textile products.
- Intensifying value addition of the current manufactured products to ensure export of high technology products.
- Stepping up measures to ensure high quality and standards of manufactured products for better competitiveness.
- Encouraging research, development and innovation; industry and research institutions linkages.

- Address domestic factors that present binding constraints to the manufacturing sector. Among these binding constraints are transport, energy and telecommunications infrastructure challenges; insecurity and macroeconomic challenges including ensuring access to affordable investment and trade finance for manufacturing sector entrepreneurs.

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CHAPTER 8

International Trade Processes and Tax Policy

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8.1. Background of The East African Community

Cooperation in trade liberalization and development is one of the fundamental pillars of the East African Community (EAC)[5]. For this purpose, the EAC Partner States agreed in the EAC Treaty of 1999 'to establish among themselves Customs Union, a Common Market, subsequently a Monetary Union and ultimately, a Political Federation[6]. The East African Community Customs Union (EACCU) commenced its operations within Kenya, Tanzania and Uganda on 1 January 2005. Burundi and Rwanda acceded to the EAC in July 2007.

In the EAC, as in many other countries, Customs[7] is on the forefront of the various agencies that intervene in international trade in goods. Customs is, for instance, deeply involved in controlling goods which cross borders, determining goods' nomenclature and origin, and collecting revenue as well as administering trade policies. Hence, the manner in which Customs operates highly affects international trade either negatively or positively. In other words, the manner in which Customs operates can either complicate or simplify the international trade in goods. And this introduces us to the concept of trade facilitation.

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[5] *EAC Treaty - 1999*, Article 74.

[6] *EAC Treaty - 1999*, Article 5, p. 15.

[7] Chapter 2 of the *General Annex to the Revised Kyoto Convention* defines 'Customs' as the Government Service which is

responsible for the administration of Customs law and the collection of duties and taxes and which also has the responsibility

for the application of other laws and regulations relating to the importation, exportation, movement or storage of goods.

8.1.1. Objectives of the EAC Customs Union

Customs unions all over the world are the same in principle. Their main goal is to liberalize and promote cross-border trade among the member states. Thus, in design and effect, customs unions have basic features that aim at fully utilizing the existing potential of member states for promoting economic cooperation in various areas.

A customs union provides an opportunity to optimize complementarities in trade, investment, production and so on of the member states.

The EAC Customs Union is not any different. According to Article 3 of the Protocol on the

Establishment of the EAC Customs Union, its objectives are:

(a) Further liberalization of intra-regional trade in goods, on the basis of mutually beneficial trade agreements among the Partner States;

(b) Promotion of efficiency in production within the Community;

(c) Enhancement of domestic, cross-border and foreign investment in the Community; and

(d) Promotion of economic development and diversification in industrialization in the Community

8.2. Trade Policies Instruments In East African Community (EAC)

8.2.1. Introduction

The main trade policy instruments of the EAC Customs Union are contained in the Protocol (Protocol on the Establishment of the East African Community Customs Union), the EAC Customs Management Act (CMA) and the EAC Customs Management Regulations.

Together, these provide for the implementation of a number of measures including, but not limited, to transitional ones and gradual elimination of internal tariffs, establishment of a common external tariff (CET), introduction of EAC Rules

of Origin (ROO) and other trade-related aspects and legal and institutional arrangements, a customs valuation system and harmonized customs laws, procedures and documentation. We shall now look at each of these instruments.

8.2.2. The Customs Management Act (CMA)

The East African Community Partner States agreed that the CU would be managed in accordance with the customs law of the Community. In addition, they decided to put in place a decentralized administrative structure for the CU, under which functions such as revenue collection would continue to be handled by the respective national revenue authorities, while the proposed Directorate of Customs and Trade under the EAC Secretariat would handle policy issues. Consistent with this understanding, on December 16th, 2004, the East African Legislative Assembly (EALA) enacted the EAC CMA to govern the administration of the CU, including legal, administrative and operational matters.

Furthermore, Partner States adopted the East African Community Customs Management Regulations, 2006. The CMA and the Regulations have been reviewed and amended several times to improve implementation of the customs union.

8.2.3. The Elimination of Internal Tariffs

The Treaty establishing the EAC recognizes asymmetry as a core principle underpinning the EAC customs union. In that regard, Articles 10 and 11 of the EAC CU Protocol provided for the elimination of all internal tariffs and other charges of equivalent effect on trade amongst partners states as well as a progressive approach to implementation of the customs union through a five year transitional period.

The inclusion of asymmetry is justified on the basis of the understanding that the EAC Partner States are at different levels of economic development and that the existing imbalances, which could indeed be exacerbated by the customs union, need to be addressed.

In that regard, the Protocol provided that:

(a) goods to and from the Republic of Uganda and the United Republic of Tanzania were to be duty free;

(b) goods from the Republic of Uganda and the United Republic of Tanzania into the Republic of Kenya were to be duty free, while

(c) goods from the Republic of Kenya into the Republic of Uganda and the United Republic of Tanzania were to be categorized into two categories i.e. Category A goods, which were eligible for immediate duty free treatment and Category B goods which were eligible for gradual tariff reduction during the five-year transitional period.

8.2.4. The EAC Common External Tariff

A common external tariff (CET) refers to an agreed set of duties levied on imported goods entering any EAC Partner State from non-EAC member countries. It is a tariff charged on trade with non-members by all countries in the EAC customs union.

The trade regimes in the EAC had there before been characterized by a "cascading" of tariff structure, according to which there were very low rates on raw materials and capital goods, moderate rates on intermediate goods and highest rates on consumer goods.

However, the EAC Partner States made efforts to reduce their simple average tariffs by almost 50% in the period 1994 – 1997. Table 8.56 shows the evolution of the tariff regime in the three original members of the EAC in the period 1994-2004.

Table 8.56: The Evolution of Tariff Regimes in the EAC

Years	Uganda			Kenya			Tanzania		
	Simple Average	Maximum Rate	Tariff Bands	Simple Average	Maximum Rate	Tariff Bands	Simple Average	Maximum Rate	Tariff Bands
1994	16.01	30.0	-	34.27	62.0	-	18.2	110	-
1997	13.2	20.0	4.0	18.4	35.0	5.0	21.8	50.0	9.0
1999	9.0	15.0	3.0	16.3	35.0	5.0	16.1	25.0	5.0
2004	7.0	15.0	3.0	16.1	35.0	5.0	14.3	25.0	3.0

Source: Nganga (2006)

On June 23, 2003 the three countries reached an agreement on the CET for the planned CU. The

CET has three bands:

- 0% for meritorious goods, raw materials and capital goods;
- 10% for intermediate goods; and
- 25% for consumer goods.

The Partner States agreed to review the maximum rate of the CET after a period of five years from the coming into force of the CU (Art. 12 [2]). The East African Community Council undertook to approve the CET structure and approve measures designed to remedy any adverse effects, which any of the Partner States may experience in the course of implementation, or in exceptional cases, to safeguard the interests of the Community[8]. For 58 sensitive products, the CET on third country imports is above the maximum CET band of 25%, reaching 100% for some products.

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[8] All EAC Partner States maintain a negative list of imports banned for health and security reasons. The lists follow international rules.

8.2.4.1. Sensitive Products

EAC Partner States undertook to identify a list of sensitive products where potentials for domestic production and cross-border trade existed and whose importation form outside the community could affect domestic production.

Such products were to be given additional protection over and above the maximum 25% duty. By commencement of the Customs Union, the Partner States had agreed on the classification of sensitive products and the applicable rates of duty. They also agreed that sensitive products could not be protected by the maximum rate and therefore required special policy measures. The Partner States agreed that the sensitive items would attract rates of over 25% and, in some cases, a mixture of specific duty and *ad valorem* rates.

8.2.5. Rules of Origin

The purpose of the EAC Rules of Origin (ROO) is to implement the provisions of Article 14 of the Customs Union Protocol and to ensure that there is uniformity among Partner States in their application.

The EAC ROO refer to a set of criteria used to distinguish between goods produced within the EAC and, therefore, eligible for EAC preferential treatment against those produced outside the EAC customs territory that attract duties specified in the CET. Towards the end of 2002 the EAC Partner States adopted a set of rules of origin[9]. Under the EAC trade regime, goods qualify for EAC tariff treatment if they originate in the Partner States. This means that all goods that meet the requirements of the EAC ROO qualify for EAC tariff treatment when they are traded within the region.

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[9] Rules of origin are the criteria used to determine the origin of a product in order to qualify for preferential treatment. They are necessary because goods may be subjected to different discriminatory measures depending on their origin. Duties and restrictions charged on imported goods may vary according to the origin of the product. Rules of origin therefore help to determine who shall receive what form of treatment (e.g. most-favored nation or preferential, etc).

According to Rule 4 on Origin Criteria, goods are accepted as originating in a Partner State if:

(a) they have been wholly produced[10];

(b) they have been produced in a Partner State, wholly or partially from materials imported from outside the partners state or of undetermined origin by a process of production which effects a substantial transformation of those materials, such that:

    (i)   the cost, insurance and freight (C.I.F) value of those materials does not exceed 60% of the total cost of the materials used in the production of the goods;

    (ii)   the value added resulting from the process of production accounts for at least 35% of the ex-factory cost of the goods as specified in the First Schedule of the ROOs; and

    (iii)   the goods are classified or become classifiable under a tariff heading other than the tariff heading under which they were imported in the Second Schedule of the ROOs.

Similarly, Rule 4 defines the principles for cumulative treatment.

The above notwithstanding, certain operations and processes are considered insufficient to support a claim that goods originate from a Partner State (Rule 7). They include packaging or placing in flasks, bags, cases, boxes and any other simple packaging; simple mixing of ingredients, simple assembly of components and parts imported from outside a Partner State, etc changes of packaging, marking, labeling, or affixing, etc. The implementation of the EAC ROO instruments (the EAC Certificate of Origin and the EAC Simplified Certificate of Origin) commenced on July 1st, 2007.

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[10] For example, mineral products extracted from the ground or sea-bed of, vegetable products harvested, live animals born and raised in, products obtained by hunting or fishing, etc – all in a Partner State)

8.2.6. Removal of Non-Tariff Barriers

According to the second EAC Development Strategy (2001-2005), major impediments to trade in the region are NTBs related to administrative and bureaucratic inefficiencies. Poor infrastructure and communication are among the obstacles to the growth of trade.

The EAC committed itself to promote projects and strategies that lead to the elimination of obstacles to trade, with serious attention being given to the implementation of identified infrastructure programs and projects to improve efficiency.

Another category of NTBs relates to standards and technical requirements (technical barriers to trade (TBTs). When these standards and requirements are imposed unilaterally to protect local industry, they can have a severe restrictive impact on trade.

Consequently, the Partner States agreed to take measures, including introducing regulations that would ensure that products accepted in one Partner State are also accepted in the market of the other Partner States.

The regional bureaus of standards were urged to speed up the harmonization of the remaining standards as East African standards. Consistent with the above, Article 13 of the EAC CU Protocol provides for the removal of all the existing non-tariff barriers (NTBs) to the importation into their respective territories of goods originating in other member states, and thereafter not to impose any new NTBs. They also agreed to put in place a mechanism for monitoring the removal of NTBs (Article 13 [2]).

8.2.7. Establishment of an Exemptions and Remissions Regime

The Customs Management Act provides some guidance on the modalities of handling of the remissions and exemptions of import duty. Under sections 138, 139 and 140, the Council may grant remission of duty on goods imported for the manufacture of goods in Partner States and prescribe regulations on the

general administration of the duty remission. The special concessions are granted on special grounds including the need to enable infant industries attain meaningful levels of competitiveness or for attainment of national policy objectives.

For instance, the exemptions on paper and paper products are largely driven by governments' universal obligation for access and affordability of education services. However, products which benefit from the exemptions and remission are supposed to attract full duties when exported to other EAC Partner States. In addition, similar products imported into a Partner State from another Partner State should be treated as local products.

Some examples of the notable remissions are given below:

- Approval of Ugandan list of raw materials and industrial inputs (225 tariff nos.) from 94 companies for duty free importation for five years with effect from 1st January 2005 under the Duty Remission Scheme of the Customs Management Act (139) under Legal Notice No. EAC/10/2007 of 18th June, 2007.

- Approval of Tanzanian manufacturers and quantity of completely knocked down (CKD) motorcycles and bicycles to be imported for fiscal year 2008/09 under Legal Notice No. EAC/29/2008 of 30th September, 2008.

- Approval of Kenya manufacturers and quantities of paper to be imported for 12 months under Legal Notice No. EAC/29/2008 OF 30th September, 2008.

- Other products which have been granted special concessions or considerations include: Paper and paper products, cement, sugar and scrap batteries under Legal Notice No. EAC/29/2008 of 30th September, 2008.

Other trade policy instruments of the EAC are found in the annexes of the Protocol on the Establishment of East African Community. There are 9 annexes

which form an integral part of the Protocol establishing the EAC Customs Union. The annexes contain specific regulations intended to implement the various elements of the customs union and translating economic opportunities for the people of East Africa. These include the following:

8.2.7.1. Annex I: Harmonized Commodity Description and Coding System (EAC Common External Tariff)

This constitutes the nomenclature established under the International Convention on the

Harmonized Commodity Description and Coding System approved by the Customs Cooperation Council in June 1983 and amended as at June, 2007. It includes the general rules for the interpretation of the harmonized system, abbreviations and symbols, section, chapter and subheadings and the headings and subheadings. Each heading is identified by four digits, the first two indicating the chapter number and the second two the numerical order in which the heading appears within the chapter. The heading numbers are shown in the first column. The second column contains the eight-digit codes of the harmonized system as transposed at the EAC level.

The fourth column contains units of quantity for use when reporting statistics based on the harmonized system. The fifth column contains applicable common external tariff rates. The handbook comprises schedule 1 – comprising 21 sections, with duty rates under the three band tariff rates – and schedule 2 which has duty rates of sensitive products.

8.2.7.2. Annex II: Program and Modalities for Elimination of Internal Tariffs

These include the transitional provisions on the elimination of internal tariffs for goods exported from Kenya into Tanzania and Uganda. In other words, goods from the Republic of Kenya into the Republic of Uganda and the United Republic of Tanzania shall be categorized as:

- Category A goods, which shall be eligible for immediate duty free treatment, and
- Category B goods, which shall be eligible for gradual tariff reduction.
- Category B goods from Kenya into Uganda which were to have a phase out tariff reduction period of five years for all products, and those from Kenya into Tanzania which were to be phased out in different classifications with the highest being levied 25% tariffs.

8.2.7.3. Annex III: The East African Community Customs Union (Rules of Origin) Rules

The purpose of the rules is to implement the provisions of Article 14 of the Protocol and to ensure that there is uniformity among Partner States in the application of the rules of origin and that to the extent possible the process is transparent, accountable, fair, predictable and consistent with the provisions of the Protocol.

8.2.7.4. Annex IV: The East Africa Community Customs Union (Anti-dumping Measures) Regulations

Regulations in this annex were intended to implement Article 16 of the Protocol by recognizing the prohibition of dumping if it causes or threatens material injury to an established industry in any of the Partner States, materially retards the establishment of a domestic industry therein or frustrates the benefits expected from removal or absence of duties and quantitative restrictions of trade between Partner States.

8.2.7.5. Annex V: The East African Community Customs Union (Subsidies and Countervailing Measures)

These were intended to facilitate implementation of Articles 17 and 18 of the Protocol on subsidies and countervailing measures, respectively. If a Partner State grants or maintains any subsidy, including any form of income or price

support which operates directly or indirectly to distort competition by favoring certain undertakings or the production of certain goods in the

Partner State, it shall notify the other Partner States in writing. On the other hand, the Community may, for the purpose of offsetting the effects of subsidies and subject to regulations made under this article, levy a countervailing duty on any product of any foreign country imported into the customs union. The countervailing duty shall be equal to the amount of the estimated subsidy determined to have been granted directly or indirectly, on the manufacture, production or export of that product in the country of origin or exportation.

8.2.7.6. Annex VI: The East African Community Customs Union (Safeguard Measures)

Partner States agreed to apply safeguard measures to situations where there is sudden surge of a product imported into a Partner State under conditions which cause or threaten to cause serious injury to domestic producers in the territory of like or directly competing products within the territory. Besides during the transitional [period of five years, after the coming into force of the customs union protocol where a Partner State demonstrates that its economy will suffer serious injury as a result of the imposition of the common external tariff on industrial inputs, raw materials, the Partner State concerned shall inform the Council and the other Partner States through the Secretary General on the measures it proposes to take.

8.2.7.7. Annex VII: The East African Community Customs Union (Export Processing Zones) Regulations

The purpose of these regulations is to support export promotion schemes in the community to accelerate development, promote and facilitate export oriented investments, produce export competitive goods, develop an enabling environment for export promotion schemes and attract foreign direct investments.

8.2.7.8. Annex VIII: The EAC Customs Union (Free Port Operations) Regulations

The purpose of these Regulations is to implement the provisions of Article 31 of the Protocol and to ensure that there is uniformity among Partner States in the implementation of free-port operations and that to the extent possible, the process is transparent, accountable, fair, predictable and consistent with the provisions of the Protocol.

2.16 Annex IX: The East African Community Customs Union (Dispute Settlement Mechanism)

The purpose of the regulations is to facilitate settlement of disputes amongst Partner States as stipulated in Article 41 of the Protocol. Each Partner State shall accord due consideration to the other Partner States' presentation or complaints, accord adequate opportunity for consultation on representations made by other Partner States and implement in good faith any decisions made pursuant to the Community's dispute settlement mechanism.

How are the instruments of the Customs Union implemented? The next section describes how these instruments are applied.

8.3. Application of the Main Instruments of The Customs Union

8.3.1. The Customs Management Act

Implementation of the CMA began on 1st January 2005 in the three EAC Partner States. Significant progress so far includes the development and adoption of the EAC customs management regulations, duty remission regulations and regulations for the working relationship between the Directorate and Customs administrations. Since its implementation, a number of reviews have been undertaken in some provisions to ensure that they suit the current trade and customs environment. Nonetheless, the administration of the CMA faces a number of challenges.

- At the national level, the main focus by Revenue Authorities as obligated by their Partner States is to maximize revenue while the regional focus is on trade facilitation. Modern Customs practices are now focusing on trade facilitation as a means to increased revenue collection. In the application of the EAC CMA officials normally lay emphasis on areas that have punitive dimension in the law rather than the trade facilitative provisions resulting into complaints against some provisions by some stakeholders in the private sector.

- Some of the provisions of the CMA have not yet been implemented. For example, among others, the appeals system had not been implemented in Kenya by the year 2009 despite the existence of appropriate provisions. Kenya had by then not established an independent appeals system hence the absence of a harmonized system for efficient and effective settlement of customs disputes.

- There are limited capacities in both the Directorate of Customs in terms of staff to effectively steer the implementation. Implementing agencies in some Partner States are also faced with technical interpretation issues.

- Except for the import declaration forms, the application of other relevant regulations and forms is not uniform throughout the region. Other areas include procedures for licensing clearing and forwarding agents and other agents which are yet to be harmonized for effective operations of the customs union.

8.3.2. Elimination of Internal Tariffs

The asymmetry principle adopted by the EAC Partner States was aimed at addressing the economic development imbalances that existed or could be exacerbated following implementation of the customs union. The temporary protection arrangements were designed to allow producers in Tanzania and Uganda sufficient time to restructure their operations to face increased competition from Kenyan imports. Thus Tanzania and Uganda maintained internal tariffs on selected imports from Kenya to be removed gradually in five

years. The program of elimination of internal tariffs started in 2005 in Uganda and Tanzania and were expected to end in December 2009 when full implementation of the customs union commenced.

Table 8.57: The Five-Year Phase-out Plan of Internal Tariffs

UGANDA		TANZANIA					
Number of Items	426	146	15	20	516	112	54
Years	Tariffs to be applied	Tariffs to be applied					
2005	10	25	15	10	5	3	2
2006	8	20	12	8	4	2	1
2007	6	15	9	6	3	1	0
2008	4	10	6	4	2	0	0
2009	2	5	3	2	1	0	0
2010	0	0	0	0	0	0	0

Source: EAC Secretariat, 2008

The 5-year transitional period, shown in Table 8.57 was intended to enable Uganda and Tanzania to adjust to the effects of the removal of internal tariffs and recover some losses in revenue. Initially, it was envisaged that the effectiveness of this arrangement depended on whether the tariffs on the earmarked items, which formed 20% of the total EAC tariff lines, would be protective enough for the affected sectors in the two Partner States and could generate the expected revenue.

8.3.3. The Common External Tariff

The EAC Partner States have continued to apply uniformly the EAC common external tariff without serious hindrances since the launch of the customs union in 2005. Consistent with the CU Protocol, the Council has reviewed duty rates of some tariff items in order to address identified inconsistencies and appropriately align the applicable rates to the economic environments of the Community. The Ministers of Finance, through a pre-budget consultation process, jointly agree on tariff policy changes to suit the economic environment prior to reading their national budgets.

In the 2007/08 budget, the Ministers of Finance of the three Partner States agreed on specific tariff measures, including updating of the EAC Common External Tariff 2007 Version in conformity with the World Customs Organization instrument of the Harmonized Commodity Description and Coding System, Version 2007.

The adoption of the EAC Common External Tariff has brought about a number of advantages to the region. First, it has greatly liberalized the EAC region. For instance:

- The average applied tariff presently is 11.6% compared to 16.8% for Kenya and 13.5% for Tanzania before the customs union came into force. However, in the case of Uganda there was an increase in the average applied tariff from 9% prior to the customs union.

- Secondly, it has enhanced predictability to exporters and investors into the region alike. In addition, it has also facilitated the locking-in of trade policy and the regional integration process.

However, the CET has also had different effects on the trade regimes in the member countries. The introduction of the three-band tariff structure meant an increase of tariffs in Uganda (and to a lesser degree in Tanzania), and a reduction of tariffs in Kenya. In Uganda, 3,066 tariff lines were expected to increase compared to 1,224 in Tanzania and 1,144 in Kenya. The reverse was expected to happen for Kenya, where the CET has lowered significantly more tariffs (3,216) than in Tanzania (2,364) and in Uganda (1,353). In addition, the World Bank estimated that, with the full implementation of the CET, the simple average in the three countries would stand at 10.9%, representing a significant decline for Kenya from a simple average tariff of 16.6% and a smaller decline for Tanzania from a simple average tariff of 14.3%. On the contrary, Uganda's simple average tariff was expected to increase by about 20%.

Besides, the CET has also led to an increase in tariff dispersions from one product to another, across products within sectors and across stages of production. At the

sectoral level, tariff dispersion increased in 16 of 21 sectors and rose to levels above 100% in 5 of these sectors. This has created three major problems:

- First, a highly dispersed tariff schedule creates incentives to misallocate resources i.e. investments and labor flow to industries with the greatest government protection and away from where productivity is highest.
- Secondly, setting different tariff rates on similar products provides an incentive for companies to misclassify imports and facilitates corruption.
- Thirdly, the Partner States have different tariff bindings at the WTO which are also different from the applied Most Favored Nation (MFN) rates. Such a state of affairs sends mixed signals to potential investors who may be deterred by the uncertainty regarding the customs duties.

Table 8.58 shows the binding overhangs for the three countries.

Table 8.58: Binding Overhang in Kenya, Tanzania and Uganda

Country	Product (HS heading)	WTO Bound rate	Applied MFN Rates (2005)
Kenya	Agricultural products	100	0-25
	Fresh fish (0302)	62	25
	Frozen fish (0303)	62	25
	Medicaments (3003)	35	0
	Pharmaceutical goods (3006)	18	0-25
	Fertilizers (3105)	31	0
	Primary ethylene polymers (3109)	31	0
	Tractors (8701.90)	62	0
Tanzania	Agricultural products	120	0-25
	Silk fabrics (5007.0)	120	25
	Woven fabrics of coarse animal hair (5113.10)	120	25
	Hydraulic water turbines (8410.13	120	0
	Diesel electric locomotives (8602.10)	120	0
	Dummies and other lay figures (9610.00)	120	25
	Antiques (>100 years)(9607.00)	120	25
Uganda	Agricultural products (60, various)	40-70	0-25
	Non-agricultural goods (about 80)	40-70	0-25

Source: WTO Schedules for Kenya, Tanzania and Uganda and EAC CET

The EAC Partner States have continued to implement the three-tier external tariff band structure of 0%, 10% and 25% consistent with the arrangement under the

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EAC Customs Union. Under the zero-tariffs, Kenya imported goods worth US$ 4,602.2 million in 2006 compared to US$ 3,871.1 million in 2005 representing an increase of 18,9%. Imports under the 0% band accounted for 63.6% of total imports in 2006. Major import products included mineral fuels and products thereof; vehicles other than railway and parts and accessories thereof; boilers, machinery and mechanical appliances; aircraft, spacecraft; and electrical machinery and equipment. All the items listed registered increases in value between 2005 and 2006, with the exception of the aircraft category which declined by 2.3 percent (EAC Secretariat, 2008).

For Uganda, the value of goods imported under the 0%-band accounted for 67.9%. The top three imports in the 0% band were medicaments, radio/TV transmission apparatus, and palm oil. These were imported mainly from India, South Africa, the USA, United Kingdom, Japan, Netherlands, Germany and Malaysia. The value of imports under the 10% fell by 1.7% and its contribution to total imports value was 9.8%. These were primarily pneumatic tyres for buses and lorries, vehicle parts, and rolled iron and steel, imported mainly from India, South Africa and China. The 25% tariff band accounted for 19.3% of total import value and increased by 5.0%. The top three imports in the 25%-band were vehicles of cylinder capacity exceeding 2,250 cc but below 3,000.

For Tanzania, total imports under the CET rose to US$ 4,160.6 million in 2006 up from US$ 2,802.3 million in 2005, accounting for 96% of total imports (EAC Secretariat, 2008)7. An estimated 57.3% of EAC CET imports were under the 0% tariff band and these were mostly industrial raw materials and capital goods. The surge of imports of such goods is attributed in part to the current macroeconomic reforms, which have continued to attract large investments in manufacturing, mining, communication, tourism, and transportation.

8.3.4. Designated list of sensitive products

The EAC trade regime has designated 58 goods as sensitive products and set advalorem tariffs ranging from 35% to 100% i.e. 35, 40, 45, 50, 55, 60, 75

and 100. The top rate of 100% applies to most varieties of sugar; high rates also apply to rice (75%); wheat (60%), milk and various milk products (60%) and maize (50%). This measure was intended to protect local production on the assumption that the region had adequate capacity to meet the demand for the selected commodities

Table 8.59: CET Rates for Selected Sensitive Products

Product	Rate (%)
Milk and cream	60
Wheat and meslin grain	35
Wheat and meslin flour	60
Maize	500
Ricee	75
Cane and Beet Sugar	100
Khanga, Kikoy, Kitenge	50
Worn Clothes	45

Source: EAC Secretariat 2008

The tariff protection rates were agreed upon at the regional level. However during the Pre-

Budget consultations of Ministers of Finance, some reviews have been done in response to the economic and trade environment. A notable example is the review of CET rate of cement to 25% in 2008 for a period of two years to address the shortages that were being faced in the region.

Some Partner States that have found challenges with the rates for sensitive products have submitted requests to stay application of the CET and apply rates that support particular sectors.

For example Kenya submitted a request for stay of application of CET rate on rice from Pakistan to apply 35% import duty instead of 75% for a period of two years.

The import values of sensitive products from non-EAC countries increased by 96.5%. The top three items under the sensitive schedule were worn clothing, primary cells and rice (EAC Secretariat, 2008). The request to stay application

of the CET rate is a cause of concern because it is bound to distort trade and encourage smuggling in an otherwise free trade area. For example, an applied rate which is low than the prescribed additional duty (implying lower protection) encourages smuggling into countries with higher protections. The Partner States are aware of this problem and are currently working on it to find a lasting solution.

8.3.5. Application of the EAC Rules of Origin

The WTO rules provide that member countries seek to ensure that rules of origin which define the origin of a product are transparent and do not in any way restrict, distort or disrupt trade. At the same time, the rules of origin must be based on a positive standard and administered in a consistent, uniform, impartial, and reasonable manner. The WTO also allows members in a free trade area, such as the EAC, to apply different rules of origin for products traded under their free trade agreement. The agreement establishes a harmonization work program, based upon a set of principles, including making rules of origin objective, understandable, and predictable.

Much progress has been achieved in the application of the EAC Rules of Origin. In addition, the EAC Partner States have adopted simplified Rules of Origin in a bid to make it easier for small business persons to engage in cross-border trade. However, some issues have been raised with regard to the application of the Rules of Origin.

First, the capacity and competence of the issuing authorities are a major concern. In some cases, limitations have led to bureaucratic delays in the issuance of certificates of origin, which, in many cases, affects exporters of perishable products. For example, the compulsory certificate of origin from the Uganda Export Promotion Board (UEPB) may take more than a week to issue for one consignment and may be rejected in the other EAC Partner States. Similar bureaucratic red-tape was observed in the case of Namanga Tanzania, where issuance of the simplified certificate of origin for goods valued at not more than

USD 500 is a concern for small scale importers. The study survey by Mugisa, Onyango and Mugoya (2009) established that the certificates used for cross-border trade in Kenya's Busia and Malaba borders, are issued from the regional revenue offices based at Kisumu, making it difficult for majority of traders in the region to acquire them.

Despite the introduction of the Simplified Certificates of Origin for goods valued at less than US$ 500, this study noted that their use is still very limited. In fact, samples of these certificates were not only available at all border points, but the study team established ignorance about the simplified certificates by both traders and customs officials at Malaba and Busia borders.

Secondly, the understanding, interpretation and appreciation of the rules of origin are still limited in most Partner States, particularly for companies which produce for the local market. This was the case in Uganda, for example. At the sometime, the survey established greater use of the

COMESA certificates of Origin at Busia and Malaba borders as opposed to the EAC certificates.

Limitations in access and efficiency in issuance of certificates tend to encourage cases of fraud, where importers present fake or fraudulent certificates of origin for goods which would normally not qualify for preferential treatment. At the same time, there also seems to be negligence on the part of some authorities who do not necessarily abide by the manual for application of the Rules of Origin.

Thirdly, there are different issuing authorities for certificates of origin with the EAC Partner States. For instance, while Kenya Revenue Authority and Tanzania Chamber of Commerce,

Industry and Agriculture (TCCIA) issue the certificates on behalf of the Governments of Kenya and Tanzania respectively; Uganda Export Promotion Board does the same on behalf of Uganda Revenue Authority in the case of

Uganda. This does not only create confusion in the interpretation, application and enforcement of the various requirements but also contravenes the

2006 Council decision that recommended that the revenue authorities for Kenya and Uganda and TCCIA for Tanzania to be the issuing authorities.

Finally, some industry players, e.g. motor vehicle exporters in Kenya, have raised concerns over the impact of some rules on the promotion of regional trade and development. For instance, the application of the Change in Tariff Heading (CTH) criteria and the definition of '*substantial transformation'*, denies Kenya's local motor vehicles assemblers' opportunity to benefit from the EAC tariff preferences.

8.3.6. Establishment of an Exemptions and Remissions Regime

This instrument has greatly facilitated harmonization of exemptions at the regional level which in turn boosted investment confidence in the EAC region. This partly explains the increased trends and expanded scope of industries benefiting from the scheme. For instance, the value of goods that qualified for exemptions and remissions in all the three countries has been growing. In

Kenya, it increased by 71.2% to US$ 1,370.8 million in 2006 up from US$ 588.8 million in 2004.

In Tanzania, it rose by 36% from US$ 798.0 million in 2004 to US$ 1,225.9 million in 2006. In

Uganda, it grew from US$ 109.8 million to US$ 178.8 million in 2005 before falling slightly to US$ 174 million in 2006.

On the other hand, in all the three countries, the revenue foregone increased in the same period. In Kenya it rose to US$ 289.5 million in 2006 up from US$ 201.4 million in 2005, representing an increase of 14.3%. In Tanzania, the revenue foregone increased by 36% to US$ 405.4 million in 2006. In Uganda, revenue foregone increased by 9.9% to US$ 36.4 million in 2006 compared to

US$ 33.1 million in 2005 and US$27.2 million in 2004. The revenue foregone represented 5.1% of total revenue collections down from 5.3% in 2005. This decline was attributed to increased collections in other non-customs related taxes arising from improved tax administration and tax education and awareness campaigns conducted by the Uganda revenue authority (URA).

Other products which have been granted special concessions or considerations include: Paper and paper products, cement, sugar and scrap batteries under Legal Notice No. EAC/29/2008 of 30th September, 2008.

Despite the locking-in of exemptions regime at the regional level, many challenges regarding implementation of the exemption regime have been cited. For instance, there is apparent lack categorization of exemptions and harmonization of the same with other investment incentives provided by different agencies. Currently, investment authorities in the Partner States do not provide uniform incentive packages while different agencies dealing with investment issues also offer different incentives.

Secondly, Partner States do not have an appropriate monitoring mechanism to ensure that goods benefiting from exemptions are not exported or pay full duties when exported to other Partner States. In addition, no Partner State has undertaken an evaluation to ascertain whether or not the objectives for which the exemptions are provided are actually being achieved. Thus, if not properly controlled, exemptions can also distort trade and encourage smuggling.

8.3.7. Harmonization and Development of EAC Standards

The regional bureaus of standards have been involved in harmonization of Partner States national standards as East African standards. As of January 2009 as many as 1,100 standards had been harmonized and pending gazetting for uniform application within the EAC. In addition, the bureaus of standards in the Partner States now recognize national quality marks and do not subject goods to further analysis.

Secondly, a coordination office has been created at the EAC Secretariat to deal with matters of harmonization of standards such as inspection of goods (both nationally and across borders), certification of products and systems, testing services for products, metrology, and so on.

Thirdly, a SQMT Act 2006 on matters of standardization, quality assurance, metrology and testing services was introduced. It lays down the infrastructure and functions both at national and regional level to facilitate trade and promote consumer protection.

Fourthly, under the German funded project – the so-called SQMT Architecture – a website (www.eac-quality.net) was created to serve as a tool for exchange of information for various players and stakeholders in the area of standards. However, the web-site has been inactive due to ownership issues. Under this project, some equipment and training has been provided and new programs have been developed.

The above notwithstanding, a number of challenges have been sited since the launch of the Customs Union in 2005 in the area of harmonization and development of standards.

- *Lack of awareness:* There continues to be limited (or no) awareness especially within the private sector about the need and/or importance of standards. This is reflected by the apathy of the business community in respect of standards. This is sometimes also true of the public sector.
- *Slow or none implementation of the Act*: There has been slow or none implementation of the above Act by Partner States. The Act provides for withdrawal of national standards in order to adopt the regional standards. However, this has not happened at the pace expected. As a result, Partner States have run parallel standards (national and regional) regimes.
- *Financial constraints:* There is a crippling lack of resources and weak coordination of the harmonization process. Partner States are currently

funding the standards harmonization process, but the resources available for this are limited. There is need for more funding to support the national efforts.

- *Lack of Technical Staffs:* The Mugisa, Onyango and Mugoya study of 2009 was also informed that the coordination office at the EAC Secretariat is understaffed. Currently, it is a "one-man" office which, even with all the willingness, cannot do much to move the process forward. There is need to employ additional technical staff with specific tasks for effective coordination of the standards programs.

- *Lack of a well-informed standards program:* There is a lack of a well-informed standards program with clear priorities for the region. Such a program would focus on selected priority sectors for which regional standards would be developed. In the absence of such a program, the tendency now is to lose focus and develop standards as they come.

- *Institutional weaknesses:* The SQMT structure currently constitutes a committee, rather than an apex body. The former cannot effectively implement existing and potential programs. This is particularly because operationalization of decisions made at higher levels may not necessarily be possible.

- *Fatigue with donor technical assistance:* This study was informed that one of the emerging issues related to standardization is fatigue related to the technical assistance provided by the donors. Apparently, while this assistance would be welcomed, it does not always address the needs and interests of the region. There is need to develop an internal mechanism for funding of standards program.

8.3.8. Adoption of the Competition Policy and Law

To guarantee fair competition, EAC adopted a competition policy which prohibits any practice that adversely affects free trade. Further in 2006, an EAC Competition Act was enacted.

However, these laws are only applicable for cross-border trade while national competition laws and institutions remain to regulate domestic trade. In Kenya competition law is contained in the Restrictive Trade Practices, Monopolies and Price Control Act of 1989. The law seeks to allow the Government to rely more on competitive elements and less on direct control. The Act provides for the control of restrictive business practices, the control of monopolies and concentration of economic power and the control and display of prices. The legislation assigned the Monopolies and Prices Commission based in the Ministry of Finance as the primary enforcement body of the competition policy. The approach is such that specific-sector regulators combine technical and economic regulation and also have some or all competition law enforcement functions. Thus, the competition authority has no jurisdiction over regulated sectors or advocacy power. However, sector regulators increasingly coordinate with the competition authority, although they are not obliged to do so. Awareness, domestication of the EAC

Competition Act and their subsequent enforcement remain a major challenge.

The situation is not much different in Tanzania where the Fair Competition Act, 2003 is the main legislation which regulates unfair competition. The Act created the autonomous Fair Competition

Commission (FCC) as well as the Fair Competition Tribunal to hear appeals, and the National Consumer Advocacy Council. The Commission can order companies to stop engaging in anticompetitive behavior and pay compensation for damages. It can also impose fines on those who commit offences under the Act. FCC has mandate to promote and protect effective competition in trade and commerce and to protect consumers against unfair and misleading market conduct throughout Tanzania. As for the regulated sectors, there are sector-specific legislative frameworks introduced in Tanzania to support transformation of the economy from a centrally-planned one into a market-driven economy that have responsibility to regulate unfair competition. They include the Energy and Water Utilities Regulatory Authority Act, 2001; the

Surface and Maritime Transport Regulatory Authority Act, 2001; the Civil Aviation Regulatory Authority Act, 2003 and the Communications Regulatory Authority Act, 2003.

On the other hand, Uganda has taken steps to adopt and domesticate the EAC competition law, but progress remains quite slow. The main instrument for this domestication is the Competition

Bill. The first draft of the Bill was sent for first reading in 2007 but was returned to the Ministry of Tourism, Trade and Industry (MTTI) in order for the latter to answer queries which had been raised by the Cabinet. In 2009, the Ministry was still working on this preparing it for the second reading. With regard to the policy, Uganda has not yet prepared a competition policy. In its absence, sector policies are being applied to address trade issues in the context of the EAC region.

8.3.9. Removal of Non-Tariff Barriers on intra-EAC trade

Consistent with Article 13 [2], in June 2007 national monitoring committees were inaugurated in all the member states for the purpose of monitoring the removal of Non Tariff Barriers. The committees are made up of specific government ministries, government departments, public agencies, local authorities and private sector organizations. They are mandated to monitor progress in the elimination of NTBs. Consequently, they meet quarterly under the chairmanship of the ministries responsible for EAC or trade, industry and investment. Issues that are not resolved at this level are referred to the Council.

While the CU has covered some ground in its implementation, there are, however, indications that in spite of the commitments made by the member states to remove NTBs, they remain a serious obstacle to trade within the region. They continue to increase the cost of doing business in the region and have negatively impacted on trade and cooperation. The most notable NTBs reported have been:

- **Customs and administrative documentation procedures** e.g. limited customs working hours, varying systems for imports declaration and payment of applicable duty rates, different interpretation of rules of origin, application of discriminatory taxes, cumbersome procedures for verifying containerized imports, diversion of transit goods, problems in blocking marketing of counterfeit products etc.

- **Immigration procedures**: Varying application of visa fees and work permits, cumbersome and duplicated immigration procedures, lack of an East African passport.

- **Cumbersome inspection requirements**: Long inspection queues during inspection of gross vehicle mass and axle loads, cumbersome and costly quality inspection procedures, quality inspection of even products that are certified by accredited laboratories, quality inspection of imports originating from amongst the EAC countries even when they have marks issued by

- Bureau of Standards, varying procedures for issuance of certification marks.

- **Police road blocks**: Police officers stop commercial vehicles even when there is no proof that goods being transported are of suspicious nature.

- **Varying trade regulations among EAC countries**: Use of harmonized COMESA axle load specifications of 16 tons for double axle by Kenya and Uganda whereas Tanzania uses 18 tons, and the gross vehicle mass (GVM) for commercial vehicles, use of different parameters on weights, labeling and quality, tolerance in measurements and the type and technology used in packaging, which limits the ability of goods to cross borders.

- **Varying, cumbersome and costly transiting procedures in the EAC countries**: Varying requirements on types of commercial trucks to be used for transit traffic, bottlenecks in offloading imports at Mombasa, unrealistic short grace periods given on imports before they start

attracting demurrage, application of insurance bonds on goods destined to the region.

8.3.10. Application of other Annexes

While some of the annexes provide for harmonization of trade related instruments, the use and application of some are driven by demand by Partner States. The Mugisa, Onyango and Mugoya (2009) study found limited application of existing instruments like safeguard measures, anti-dumping measures, subsidies and countervailing measures as corrective measures for anti-competitive trade practices within the region despite the existence of relevant provisions.

Secondly, there exists no common export support program in the EAC although Partner States are allowed to establish facilities such as manufacturing under bond (MUB), export processing zones (EPZs), duty free ports and duty draw back schemes, export promotion agencies and export credit schemes. The EAC Partner States provide quite different incentive schemes. For instance, Kenya requires a license for the export of most agricultural and mineral products, especially foods where self sufficiency is a concern and has no export quotas. Incentives under the EPZ, which mostly cover garments and apparel (over 95% of exports) exported to the US under the African Growth and Opportunity Act (AGOA), include duty and VAT exemptions from imports of machinery and raw materials, a 10-year tax holiday (for corporate and withholding taxes) and 100% investment allowances. Under the MUB, firms exporting all of their output enjoy similar benefits.

In Tanzania, there are restrictions on the exports of cereals, beans and unprocessed fish on food security grounds and taxes on exports of cashew nuts, raw hides and skins, while licenses are required for export of foods, fish, forestry products, wildlife and minerals/gems. The MUB provides tariff-free imports of capital equipment and inputs for the production of exports.

Mainland Tanzania introduced an EPZ scheme in 2002 for manufacturing including agri-processing, textiles and clothing, fish processing, leather and wood products) with limited tax exemptions. Zanzibar has a longer established scheme with more attractive incentives, mostly for garments and fish processing.

Uganda, on the other hand, prohibits exports of whole fish and timber, but appears to require less licensing than the other countries. There are taxes on raw hides and skins. Uganda has not yet established any EPZ scheme (there are plans to introduce one), although the MUB offers duty free imports for firms producing only for export.

Thus the extent of export-incentive and promotion schemes is generally in line with the importance of exports for each country while the EAC offers little in terms of establishing a common regime and promoting diversification of exports.

8.4. Opportunities and Challenges; Resolutions of Trade Conflicts

• *Lack of adequate public awareness about the Customs Union:* It will be remembered that the negotiation of the CU took a long time before it was launched in 2005. There was no time allocated to the sensitization of the stakeholders and, particularly the business community, in the three countries about what was to come. They were not sensitized on the mechanisms and benefits of the CU to allow them to position themselves to take advantage of the benefits. In fact, the CU Protocol does not provide for the involvement of the private sector in the process of implementation and to this extent the public/private sector partnership has not been enhanced.

- *Inadequate capacity:* This is demonstrated by the absence of a rationalized clearance procedures/verifications and overlaps of inspections, given the diverse roles of various agencies stationed at entry ports, lack of such important documents as manuals, the Treaty, CMA and the protocol; lack of vital equipments like computers, and budgetary constraints. In some borders there is shortage of clearance agents and some times poor knowledge of clearance requirements.

- *Resource constraints*: There were no adequate resources (both human and financial) specifically allocated for the preparatory stages of the Customs Union at the regional level. This further compounded the inadequacy in publicity and capacity development. A lot of efforts were directed at the negotiations, leaving little room for pre-launch preparations.

- *National sovereignty*: In the early stages of regional integration, the issue of sovereignty is particularly and commonly thorny. The EAC integration process is not an exception in this regard. Partner States are reluctant to change (even gradually) from national to regional orientation. This is a challenge which manifests itself in the form of non-compliance with regional laws, duplication of national activities, which would be rationally handled at regional level, such as training and exchange of information. There is bureaucratic red-tape as a result of which decisions on some matters which require urgent attentions have to be taken from the capitals (Kampala, Nairobi, Dar es Salaam, Kigali and Bujumbura).

- *Structural rigidities*: The institutional framework of the Customs Union left the customs administration in Partner States with a national, rather than regional, character. Consequently, customs in these countries remain a creation of the national legislation, while the Directorate of Customs (DC) is a design of the regional legislation. Although customs training is based on the CMA in all Partner States, the design and delivery of such training is not harmonized or regionally focused. Such disconnect between the centre and the national customs has tended to lead to differing strategic focus by the two.

- *Overlapping membership*: Overlapping membership leads to conflicting mandates (it means that exporters must comply with various tariff reduction schedules, rules of origin and other liberalization requirements) and duplication of policies and programs. It also imposes undue administrative and financial cost to the Partner States. The EAC CU Protocol anticipated these problems. Thus, under Article 37 of the

Protocol, while affirming respect for the commitments by Partner States to other regional blocs, it called for coordination of external trade policies by these Partner States. More importantly, Article 37 (3) stipulated that upon signing, the Partner States were (i) to identify issues arising from membership to the customs union, and (ii) to formulate a mechanism to govern the relationships between the EAC customs union and other regional blocs. Within the EAC, each of the Partner States belongs to at least one other regional trading block. The requirements of Article 37 (3) have not been fulfilled. While the EAC Secretariat is involved in tripartite meetings with COMESA and SADC to consult and coordinate their programs and policies, there is no policy to cover the process. Thus, the issue of multiple memberships, although still latent, is a reality which must be addressed. It is a policy decision, which the Partner States have to address sooner than later in order to consolidate the gains of the CU.

- **Un-recorded/informal trade cross-border transactions:** There is a substantial volume of unrecorded cross-border between the Partner States particularly for agricultural products despite the introduction of the simplified rules of origin certificates. This amounts to under-estimation of the volume of trade between the Partner States.

- **Lack of an appropriate mechanism for collection and dissemination of production and product-related statistical data base:** This further explains the absence of linkages between buyers and sellers in the region and dissemination of information about market conditions in terms of commodities and prices.

- **Non-Tariff Barriers:** Various government agencies and the private sector indicate that EAC Partner States recognize the negative impacts of the aforementioned NTBs on intra-EAC trade and have made substantial efforts to eliminate them or reduce their impacts. However, despite the efforts there are outstanding challenges related to clearance administrative procedures, physical infrastructures and unilateral actions

barring cross-border trade contrary to the treaty provisions are yet to be overcome.

- **_Dispute Settlement Mechanism:_** The existing dispute settlement mechanism which involves consultations with the Directorate, the coordinating ministries, enforcement agencies and sectoral committees is slow and costly to businesses. This may be partly due to lack of independence within the existing framework where officials concerned/committee members are tempted to take partisan positions regarding disputes or grievances. Besides, the effectiveness of National Monitoring Committees is doubtful given that they are not standing committees *per se* and members are those already engaged in other committees.

- **_Language barriers:_** Article 137 of the EAC Treaty provides that English is the official language, while Kiswahili is the *lingua franca* of the EAC. Currently, however, almost all the EAC laws are exclusively in English. Unfortunately, not all the stakeholders – including the business community - can speak or understand English. Many traders in the region even in the original Partner States (Uganda, Kenya and Tanzania) are not able to understand the legal, administrative texts and documentation written in English. Moreover, Rwanda and (particularly) Burundi use French (and to some extent Kiswahili) as the medium of communication.

8.5. World Customs Organization (WCO): Background

8.5.1. Introduction

The World Customs Organization (WCO) is an intergovernmental organization headquartered in Brussels, Belgium. The WCO is noted for its work in areas covering the development of international conventions, instruments, and tools on topics such as commodity classification, valuation, rules of origin, collection of customs revenue, supply chain security, international trade facilitation, customs enforcement activities, combating counterfeiting in support of Intellectual Property Rights (IPR), integrity promotion, and delivering sustainable capacity building to assist with customs reforms and modernization. The WCO maintains

the international Harmonized System (HS) goods nomenclature, and administers the technical aspects of the World Trade Organization (WTO) Agreements on Customs Valuation and Rules of Origin.

8.5.2. History

In 1947, thirteen European countries established a Study Group to examine customs issues identified by the General Agreement on Tariffs and Trade (GATT). This work led to the adoption in 1950 of the Convention Establishing the Customs Co-operation Council (CCC), which was signed in Brussels. On January 26, 1953 the CCC's inaugural session took place with the participation of 17 founding members. WCO membership subsequently expanded to cover all regions of the globe. In 1994, the organization adopted its current name, the World Customs Organization. Today, WCO members are responsible for customs controls on more than 98% of all international trade.

8.5.3. Vision and objectives

The WCO is internationally acknowledged as the global centre of customs expertise and plays a leading role in the discussion, development, promotion and implementation of modern customs systems and procedures. It is responsive to the needs of its members and its strategic environment, and its instruments and best-practice approaches are recognized as the basis for sound customs administration throughout the world.

The WCO's primary objective is to enhance the efficiency and effectiveness of member customs administrations, thereby assisting them to contribute successfully to national development goals, particularly revenue collection, national security, trade facilitation, community protection, and collection of trade statistics.

8.5.4. WCO Instruments

In order to achieve its objectives, the WCO has adopted a number of customs instruments, including but not limited to the following:

8.5.4.1.   The International Convention on the Harmonized Commodity Description and Coding System (HS Convention)

This was adopted in 1983 and came into force in 1988. The HS multipurpose goods nomenclature is used as the basis for customs tariffs and for the compilation of international trade statistics. It comprises about 5000 commodity groups, each identified by a six digit code arranged in a legal and logical structure with well-defined rules to achieve uniform classification. The HS is also used for many other purposes involving trade policy, rules of origin, monitoring of controlled goods, internal taxes, freight tariffs, transport statistics, quota controls, price monitoring, compilation of national accounts, and economic research and analysis.

8.5.4.2.   The International Convention on the Simplification and Harmonization of Customs procedures (revised Kyoto Convention or RKC)

This was originally adopted in 1974 and was subsequently revised in 1999; the revised Kyoto Convention came into force in 2006. The RKC comprises several key governing principles: transparency and predictability of customs controls; standardization and simplification of the goods declaration and supporting documents; simplified procedures for authorized persons; maximum use of information technology; minimum necessary customs control to ensure compliance with regulations; use of risk management and audit based controls; coordinated interventions with other border agencies; and a partnership with the trade. It promotes trade facilitation and effective controls through its legal provisions that detail the application of simple yet efficient procedures and also contains new

and obligatory rules for its application. The WCO revised Kyoto Convention is sometimes confused with the Kyoto Protocol, which is a protocol to the United Nations Framework Convention on Climate Change (UNFCCC or FCCC).

8.5.4.3. ATA Convention and the Convention on Temporary Admission (Istanbul Convention).

Both the ATA Convention and the Istanbul Convention are WCO instruments governing temporary admission of goods. The ATA system, which is integral to both Conventions, allows the free movement of goods across frontiers and their temporary admission into a customs territory with relief from duties and taxes. The goods are covered by a single document known as the ATA carnet that is secured by an international guarantee system.

8.5.4.4. The Arusha Declaration on Customs Integrity

This was adopted in 1993 and revised in 2003. The Arusha Declaration is a non-binding instrument which provides a number of basic principles to promote integrity and combat corruption within customs administrations.

8.5.4.5. The SAFE Framework of Standards to Secure and Facilitate Global Trade

This was adopted in 2005. The SAFE Framework is a non-binding instrument that contains supply chain security and facilitation standards for goods being traded internationally, enables integrated supply chain management for all modes of transport, strengthens networking arrangements between customs administrations to improve their capability to detect high-risk consignments, promotes cooperation between customs and the business community through the Authorized Economic Operator (AEO) concept, and champions the seamless movement of goods through secure international trade supply chains.

8.5.5. Nomenclature and Classification of Goods

All imported and exported goods must be classified for Customs purposes. Each separate product is assigned a particular classification code. Most countries classify goods in accordance with the WCO harmonized commodity description and coding system, popularly known as the Harmonized System (HS), which came into effect in 1988.

The Harmonized Commodity Description and Coding System is also referred to as the Harmonized System and it means the nomenclature comprising the headings and subheadings and their related numerical codes, the section, chapter and subheading notes and the general rules for the interpretation of the harmonized system.

For customs purposed, customs tariff nomenclature means the nomenclature established under the legislation of a Contracting Party for the purposes of levying duties of Customs on imported goods. On the other hand, statistical nomenclature means goods nomenclatures established by a Contracting Party for the collection of data for import and export trade statistics while combined tariff/statistical nomenclature means a nomenclature, integrating customs tariff and statistical nomenclatures, legally required by a Contracting Party for the declaration of goods at importation.

Go to http://www.wcoomd.org/en/topics/nomenclature/instrument-and-tools/hs_convention.aspx for further reading,

8.5.6. Valuation

With a few exceptions, most countries levy ad valorem Customs duties (i.e. duty is levied on the value of the goods). Consequently, the actual amount of duty will depend on the dutiable value determined by Customs. The WTO Valuation Agreement, adopted in 1994, introduced a valuation system based primarily on the transaction value of imported goods (i.e., the price actually paid or

payable), which now governs the majority of world trade. The WCO ensures the uniform interpretation and application of Agreement at the technical level.

8.6. Relationship between World Customs Organization and World Trade Organization (WTO)

8.6.1. Introduction

The WTO and WCO cooperate on a number of subject areas, including market access, Information Technology Agreement (ITA), customs valuation, rules of origin and trade facilitation

In the area of market access, the WTO cooperates regularly with the World Customs Organization (WCO). This cooperation concerns the classification of goods. WTO staff regularly follow the work in the WCO on the Harmonized System classification nomenclature, both for the work of the Market Access Committee as well as for that of the Committee of Participants on the Expansion of Trade in Information Products.

The Agreements on Customs Valuation and Rules of Origin contain provisions which call for the establishment of Technical Committees under the auspices of the WCO on these subjects. WTO staff maintains cooperative relations with these Technical Committees to examine questions with respect to these Agreements, as well as to assist in technical assistance activities.

With respect to trade facilitation, since 2005, WCO officials participate in all WTO regional technical assistance activities. In addition, the WCO assists in the development of the needs assessment tool which has been designed and developed specifically for the trade facilitation negotiations of the Doha Development Agenda. WCO officials regularly attend, as observers, the meetings of the Negotiating Group on Trade Facilitation.

8.6.2. Cooperation on Technical Assistance

The vast majority of technical assistance activities are in the area of customs valuation and trade facilitation. The current focus of activities (and budget) is on the trade facilitation negotiation issues. Future technical assistance cooperation might be necessary in the areas of rules or origin as more and more countries negotiate free trade agreements. Coordination of these activities is managed through contacts between staff of the respective Secretariats dealing with the relevant subject matter.

8.6.3. Schedules of Concessions on Goods

The Harmonized System (HS) nomenclature was developed by the WCO and entered into force on 1 January 1988 through a Convention. Although Article II of the GATT (Schedules of Concessions) does not establish a specific nomenclature to be used by Members in this respect, and despite the fact that other nomenclatures such as the BTN and CCCN were used in the past, the HS has become the *de facto* standard for Members in this respect. As of 31 March 2006, there were 78 WTO Members (counting the EC-25 as one) which were contracting parties to the HS Convention. In addition, practically all the remaining 47 WTO Members apply the HS in spite of not being contracting parties to it. The HS has also been used by WTO Members as a tool to define the products which are covered by certain agreements, the most important of which is probably Annex 1 of the Agreement on Agriculture. This Annex defines, in terms of Chapters, headings and subheadings of the 1992 version of the HS, which are the agricultural products. Therefore, changes in the HS have important legal implications for WTO Members, in particular with respect to their schedules.

The Harmonized System Committee of the WCO undertakes a periodic review of the HS to take account of changes in technology and patterns in international trade, and recommends amendments to the HS. The first set of such changes came into force on 1 January 1992 (HS92). A second, more substantial, set of amendments came into force on 1 January 1996 (HS96), and a third one on 1

January 2002 (HS2002). A fourth amendment entered into force on 1 January 2007 (HS2007).

Following the entry into force of the HS on 1 January 1988 (HS88), the pre-Uruguay Round schedules of those GATT Contracting Parties which were also contracting parties to the HS Convention were required to be transposed into the HS nomenclature. The "transposition" of these concessions is essential in order to ensure the transparency and predictability of the concessions, as it would otherwise be very difficult to determine whether the bindings are being respected. It is for this reason that the GATT Committee on Tariff Concessions adopted procedures for this purpose in 1983.

Special procedures were also used to introduce the subsequent HS amendments, the latest of which is the HS2007 decision contained in <u>WT/L/673</u>. The transposition of schedules has been an increasingly tricky issue to manage at the WTO, as it has proven very difficult to follow the pace of the HS amendments. It is hoped that the two last procedures which have been adopted (<u>WT/L/605</u> and <u>WT/L/673</u>), where the WTO secretariat plays a more active role, would help to ease the problem and expedite the work.

8.6.4. Harmonization of Rules of Origin

The WCO Technical Committee on Rules of Origin (TCRO) was established in 1995 by the WTO Agreement on Rules of Origin (RO Agreement) and had, since then, carried out the main work of harmonizing non-preferential rules of origin. After establishing the overall framework of the harmonized rules of origin (HRO) and completing all necessary technical work, the TCRO in June 1999 transmitted almost 500 outstanding issues for discussion and decision in the WTO Committee on Rules of Origin (CRO). On the basis of these invaluable inputs from TCRO, the CRO has been working hard to complete the remaining work.

8.6.5. Customs Valuation

The WCO Technical Committee on Customs Valuation (TCCV) was established in 1980 by the Tokyo Round Agreement of Customs Valuation. Since then the TCCV and the GATT/WTO Committee on Customs Valuation (CCV) have maintained an excellent relationship as described above. The WCO Compendium of customs valuation contains advisory opinions, commentaries, explanatory notes and case studies adopted by the TCCV, which provide very useful guidelines for addressing various technical questions on customs valuation.

8.7. Revised Kyoto Protocol

8.7.1. What is the Revised Kyoto Convention?

The Revised Kyoto Convention is widely regarded as the blueprint for modern and efficient Customs procedures in the 21st century. If implemented, it will provide international commerce with predictability and efficiency required by modern trade. The Revised Kyoto Convention elaborated on key governing principles, chief of which are:

- Transparency and predictability of Customs actions
- Standardization and simplification of the goods declaration and supporting documents
- Simplified procedures for authorized persons
- Maximum use of information technology
- Minimum necessary Customs control to ensure compliance with regulations
- Use of risk management and audit-based controls
- Coordinated interventions with other border agencies
- Partnership with the trade

Incidentally, the RKC was ratified by former President Gloria Macapagal-Arroyo in March 16, 2009 and the Senate concurred through Resolution No. 220 in February 1, 2010.

As of June 2010, there are 71 contracting parties to RKC out of the 179 members of the World Customs Organization. Philippines is the 70th and Kenya was the 71st.

The Philippine Customs deposited the Instrument of Accession of the Philippine government to the RKC at the World Customs Organization Headquarters in Brussels, Belgium last June 25, 2010.

Ten out of 21 member countries of the Asian-Pacific Economic Cooperation are signatories, namely, Australia, Canada, China, Japan, Korea, Malaysia, New Zealand, United States of America, Vietnam, and the Philippines. However, all APEC and Association of Southeast Asian Nation countries have agreed to simplify and harmonize their respective customs procedures with the RKC.

8.7.2. Is the Revised Kyoto Convention Adapted to the needs of Developing Countries?

Simplifying the procedures to move goods across borders will reduce administrative barriers, thereby encouraging small and medium-sized enterprises to become involved in international trade and attracting foreign investment. This leads to greater economic development.

Will implementation of the Revised Kyoto Convention allow Customs to maintain controls while focusing on trade facilitation?

The principles in the Revised Kyoto Convention promote trade facilitation, but also ensure that the statutory functions of the Customs are not compromised. Cross-border movement of goods is the key element in any international trade transaction and Customs presence is an essential and statutory feature for the movement of such goods.

The manner in which Customs provide for swift and efficient clearance of these goods reflects the quality of service provided by the government to the public.

The Revised Kyoto Convention provides a comprehensive set of uniform principles for simple, effective and predictable Customs procedures with effective Customs control. It, thus, responds to the key needs of both modern day Customs administrations and the demands of the international trade by providing a balance between the Customs functions of control and revenue collection and that of trade facilitation.

8.7.3. What does accession to the Revised Kyoto Convention mean for Kenya?

Accession to the Revised Kyoto Convention is a strong signal to the international trade community and governments around the world that Kenya stands firmly behind customs procedures that facilitate the secure movement of legitimate trade across national borders. It is a manifestation that the public and private sector can truly work together to facilitate trade towards the promotion of economic growth, national security and customs integrity at both national and international levels.

Accession to the RKC will give the Kenya government:

- Protection against the passage or issuance of national legislation that are against the principles and provisions of the RKS
- Solid legislative foundation for reforming and strengthening customs and related institutions
- Benchmark for assessing the status of Kenya trade efficiency and competitiveness
- Availability of shepherds and technical teams of experts to guide the reform process
- RKC management committee providing foreign companies and countries with recourse for expressing grievances when the customs service does not comply with RKC

- Most effective way of declaring globally that trade and investments are facilitated in Kenya and that the regulatory environment compares with the best in the world
- Economic growth stimulus through the modernization of Customs which attracts trade and investments
- Assurance of modern and efficient Customs service to the economy, allowing it to participate better in the international trade environment

The implementation of the standards and recommended practices of the Convention lead to the following benefits to the economy:

- Lower cost of imported goods
- Lower cost of production
- Increased economic competitiveness of national goods in the world market
- Attraction for international trade and investment
- Lower cost to consumers
- Increased national revenue

For Customs, the benefits are:

- More efficient use of customs resource
- Faster, predictable and efficient customs clearance
- Enhanced customs control
- Increased trade facilitation

For the trading community:

- Transparent and predictable procedures mean reduced opportunities for extortion facilitation/grease payments
- Greater facilities for complaint traders
- Lower business costs in terms of time and the cost of clearing imports with customs
- Clear information concerning rights and obligations

(WCO estimates that inefficient global customs procedures add 5% to 7% to the cost of goods traded globally)

8.8. Resolutions of Conflicts Under WCO

Harmonized System (HS) dispute settlement plays an important role in the facilitation of international trade. While the Harmonized System, as a multipurpose trade classification, has many different applications, its primary use for now and the foreseeable future is still the collection of import duties and taxes for revenue and/or trade policy purposes (including the protection of domestic industries). This monetary function, of course, creates the potential for disputes between duty collection authorities and persons liable for duty.

Under the Harmonized System, commodities must be clearly distinguished from one another. For each commodity or category of commodities, only one heading or subheading should be applicable, thereby precluding classification in any other heading or subheading. Generally speaking, once the classification of a good is identified in the nomenclature, the duty rate is automatically determined. Therefore, "in the beginning there was classification."

At national level, classification is designed to carry out specific government polices and it is quite rare that classification takes place purely for the sake of classification. However, classification at international level is quite different and therefore international HS dispute settlement is different. Once the classification of a good is identified in the HS Nomenclature, it must be applied uniformly all over the world. Its impact, and in particular its economic impact, may be different from country to country. The same product may be subject to low duties in one administration and high duties in another. For this reason, as well as the technical nature of the Harmonized System, disputes in the HS Committee are settled from a purely classification point of view.

However, it should be noted that this does not mean that the persons responsible for classification (the importer, the officers in charge in administrations, the WCO Secretariat, etc.) should be ignorant of the tariff and other government polices with regard to the relevant classification. Classification decisions are taken within the context of these policies and the correctness of decisions must be verified with regard to such policies and should be persuasive to various stakeholders

whose expectations with regard to the decisions may vary. Such decisions should, in particular, be defensible in national courts.

The HS Convention has set up the HS Committee as an international dispute settlement body. To date, the HS Committee has solved many disputes, thus contributing to achieving uniform classification and ensuring transparency with regard to HS classification. Some of these disputes have had a huge impact on the economies of member administrations. The following are examples:

- Whether LAN equipment falls within the category of a computer or telecommunications equipment?
- Whether high-fat cream cheese is cheese or a dairy spread?
- Whether a mixture of tobacco leaves and manufactured tobacco falls in the category of non-manufactured tobacco?
- Whether half a car (the front section of a used motor vehicle) should be considered to be part of a car or an incomplete car?
- The demarcation line between passenger motor vehicles and vehicles for the transport of goods.

Thus, the HS Committee, which acts as a kind of "international court for HS classification disputes", has played and continues to play (twice a year) a tremendously important role in the facilitation of international trade.

8.9. Economic/Regional Trading Blocs

8.9.1. Definition of Regional Trading Block

A regional trading bloc is a group of countries within a geographical region that protect themselves from imports from non-members. Trading blocs are a form of economic integration, and increasingly shape the pattern of world trade. There are several types of trading bloc:

8.9.1.1. Preferential Trade Area

Preferential Trade Areas (PTAs) exist when countries within a geographical region agree to reduce or eliminate tariff barriers on selected goods imported from other members of the area. This is often the first small step towards the creation of a trading bloc.

8.9.1.2. Free Trade Area

Free Trade Areas (FTAs) are created when two or more countries in a region agree to reduce or eliminate barriers to trade on all goods coming from other members.

8.9.1.3. Customs Union

A customs union involves the removal of tariff barriers between members, plus the acceptance of a common (unified) external tariff against non-members. This means that members may negotiate as a single bloc with 3rd parties, such as with other trading blocs, or with the WTO.

8.9.1.4. Common Market

A common market is the first significant step towards full economic integration, and occurs when member countries trade freely in all economic resources – not just tangible goods. This means that all barriers to trade in goods, services, capital, and labour are removed. In addition, as well as removing tariffs, non-tariff barriers are also reduced and eliminated. For a common market to be successful there must also be a significant level of harmonization of microeconomic policies, and common rules regarding monopoly power and other anticompetitive practices. There may also be common policies affecting key industries, such as the Common Agricultural Policy (CAP) and Common Fisheries Policy (CFP) of the European Single Market (ESM).

8.9.1.5. The European Union (EU)

The EU is the world's largest trading bloc, and second largest economy, after the USA. The EU was originally called the Economic Community (*Common Market*, or

The Six) after its formation following the Treaty of Rome in 1957. The original six members were Germany, France, Italy, Belgium, Netherlands, and Luxembourg.

The initial aim was to create a single market for goods, services, capital, and labour by eliminating barriers to trade and promoting free trade between members. In terms of dealing with non-members, common tariff barriers were erected against cheap imports, such as those from Japan, whose goods prices were artificially low because of the undervalued yen.

By 2009, following continuous enlargement, the EU had 27 members as shown in Table 8.60:

Table 8.60: Member of the European Union as at 2009

Austria	Germany	Norway
Belgium	Greece	Poland
Bulgaria	Ireland	Portugal
Cyprus	Italy	Romania
Czech Republic	Latvia	Spain
Denmark	Lithuania	Slovenia
Estonia	Luxembourg	Slovakia
Finland	Malta	Sweden
France	Netherlands	UK

8.9.2. Advantages and Disadvantages of Trading Blocs

8.9.2.1. Advantages

- **Free trade within the bloc**

Knowing that they have free access to each other's markets, members are encouraged to specialize. This means that, at the regional level, there is a wider application of the principle of comparative advantage.

- **Market Access, Trade Creation and Diversion**

Easier access to each other's markets means that trade between members is likely to increase. *Trade creation* exists when free trade enables high cost domestic producers to be replaced by lower cost, and more efficient imports. Because low cost imports lead to lower priced imports, there is a consumption effect, with increased demand resulting from lower prices.

When <u>customs unions</u> are established the flow of trade between countries involved in the new union and those outside will be affected. Customs unions eliminate barriers to trade between members, which is assumed to provide a considerable incentive to increase trade between members and to reduce trade between members and non-members. It is often easiest to appreciate the effect of a customs union by considering what happens when one country joins an existing union.

Outside a union, and operating independently, a single nation will look to exploit its <u>comparative advantage</u>. In a free trade environment, countries will trade with who they like, attempting to exploit their comparative cost advantage though <u>specialisation</u>. They will export goods they produce most efficiently, and import goods from low-cost countries who have exploited their own comparative cost advantage to produce cheap exports. In a situation where countries do not trade freely, by imposing tariffs, or by favouring one country over others in terms of tariff levels, trade will be distorted and the pattern of trade will change. <u>Inefficient</u> producers may be protected and encouraged, at the expense of more efficient imports hence **trade diversion**.

- **Economies of scale**

Producers can benefit from the application of scale economies, which will lead to lower costs and lower prices for consumers.

- **Jobs**

Jobs may be created as a consequence of increased trade between member economies.

- **Protection**

Firms inside the bloc are protected from cheaper imports from outside, such as the protection of the EU shoe industry from cheap imports from China and Vietnam.

8.9.2.2.   Disadvantages

- **Loss of benefits**

The benefits of free trade between countries in different blocs are lost.

- **Distortion of trade**

Trading blocs are likely to distort world trade, and reduce the beneficial effects of specialization and the exploitation of comparative advantage.

- **Inefficiencies and trade diversion**

Inefficient producers within the bloc can be protected from more efficient ones outside the bloc. For example, inefficient European farmers may be protected from low-cost imports from developing countries. *Trade diversion* arises when trade is diverted away from efficient producers who are based outside the trading area.

- **Retaliation**

The development of one regional trading bloc is likely to stimulate the development of others. This can lead to trade disputes, such as those between the EU and NAFTA, including the recent Boeing (US)/Airbus (EU) dispute. The EU and the US have a long history of trade disputes, including the dispute over US steel tariffs, which were declared illegal by the WTO in 2005. In addition, there

are the so-called **beef wars** with the US applying £60m tariffs on EU beef in response to the EU's ban on US beef treated with hormones; and complaints to the WTO of each other's generous agricultural support. During the 1970s many former UK colonies formed their own trading blocs in reaction to the UK joining the European common market.

8.9.3. Opportunities and Challenges of Trading Blocs

8.9.3.1. Opportunities

Countries establish trading blocs because they believe free trade benefits their consumers by providing higher quality at lower cost. Such blocs tend to be regional because it is easier to come to an agreement with a few neighbors than with many remote partners. Small companies face challenges when their home markets open up to external competition and their native competitors become even bigger. If small businesses can address these challenges successfully, regional trading blocs can provide them with additional opportunities for growth.

Economies of Scale

A key argument for the creation of trading blocs is that the larger markets result in higher efficiency and productivity through larger factories and lower overhead. Such factors benefit large businesses that can scale up their production and save money. The operations of small businesses are not large enough to generate substantial savings in this way, and small companies may not even be able to finance such expansion. After the creation of regional trading blocs, small companies may find that they are dealing with more and larger competitors. To survive, they must maintain the strategy that allowed them to succeed against larger competition in the first place.

Relocation of Operations

In addition to economies of scale, regional trading blocs allow large companies to place facilities where the costs are lowest, without incurring tariffs or duties.

They may produce labor-intensive parts where worker pay is low and high-tech goods where the workforce is educated. Small companies don't have production large enough to separate in this way, and after the establishment of regional trade blocs, they suffer from pricing pressures as their larger competitors manufacture products at lower costs.

Cost Reduction

As prices come under pressure from economies of scale and the relocation of factories, the cost of supplies and parts drops as well. While their prices are under pressure, small companies may find that they can source raw materials and manufactured parts at lower cost from new suppliers. Small businesses that position themselves to take advantage of such cost reductions can thrive in regional trading blocs. The key is to anticipate where costs may decline, adjust company strategy to prepare for the corresponding adjustments and implement the changes quickly.

New Markets

Even if small companies adjust to the new cost and price levels, they may see their sales volume drop as they receive less money for the same products. To ensure their survival in a regional trading bloc, they have to increase sales by expanding into the new markets the trading bloc has opened up. A small business that has made the adjustment to the new price and cost levels very quickly may have an advantage over its small-company competition in the new markets. In this case, it can benefit from a competitive advantage to take over market share. Small businesses face substantial headwinds from regional trading blocs; however, if they adopt a flexible approach and adjust to the new situation rapidly, they can grow more quickly than when limited to their national environment.

8.9.3.2.   Challenges

Erosion of Multilateral Trade

Taken as a trend, regional trading blocs amount to a dangerous erosion of the system of multilateral trade on which global prosperity depends. Bilateral deals impose so much paperwork and bureaucracy on trade that companies rarely make use of their provisions.

When bilateral agreements are attractive to companies, it is often for the wrong reasons. Many bilateral trade deals offer favourable treatment to a few companies from a particular country at the expense of all the rest from elsewhere in the world. The companies that lose out may well be lower-cost producers, since such agreements are dictated more by politics than by economics. If so, the economy will suffer. Even if such a deal is eventually superseded by a broader one, it may already have caused long-term damage by allowing less efficient firms to become entrenched. Economies that are too small to extract concessions from their bigger bilateral negotiating partners fare particularly badly.

Conflicting Policies

Then there is the complexity of the growing number of bilateral and regional deals. Each has its own rules and administrative requirements, leading to a confusing spaghetti (or perhaps noodle soup) of preferential agreements, instead of the predictability that multilateralism promises. As such agreements multiply; there is less chance that they create the wealth that their authors claim.

Delay in Decision Making

Some claim that the tricky issues that stand in the way of a multilateral deal can be more easily resolved when only two countries are sitting at the table. That rarely happens: in the rush to conclude an agreement, such issues are often shelved. India's deal with ASEAN in 2010, for instance, put aside the poisonous question of farm trade, which was one of the deal-breakers in the Doha talks in 2011.

Bilateral agreements, thus, do not, on the whole, serve as stepping stones to a comprehensive global deal. On the contrary, they both distract governments

from the multilateral process and offer cover for politicians' failure to advance it. Moreover, the fear of losing favourable treatment in a bilateral agreement can deter governments from talking tough in multilateral negotiations.

 Some defenders of bilateralism admit all this, but cling to one argument they regard as clinching—that bilateral agreements are at least possible, whereas the chances of concluding Doha seem ever more remote. The comparison, they say, is not between local deals and a global one, but between regional deals and no deals at all.

 An international trade policy is a set of rules and regulations that are intended to change international trade flows, particularly to restrict imports. Every nation has some form of trade policy in place, with public officials formulating the policy which they think would be most appropriate for their country. Their aim is to boost the nation's international trade. The purpose of trade policy is to help a nation's international trade run more smoothly, by setting clear standards and goals which can be understood by potential trading partners.

8.9.4. Regional Blocs Trade Policies

In many regions, groups of nations work together to create mutually beneficial trade policies.

Trade policy can involve various complex types of actions, such as the elimination of quantitative restrictions or the reduction of tariffs hence **free trade or trade liberalization**. According to a geographic dimension, there is unilateral, bilateral, regional, and multilateral liberalization. According to the depth of a bilateral or regional reform, there may be free trade areas (wherein partners eliminate trade barriers with respect to each other), 'custom unions' (whereby partners eliminate reciprocal barriers and agree on a common level of barriers against no partners), and free economic areas (or deep integration as in, for example, the European Union, where not only trade but also the movement of factors has been liberalized, where a common currency has been instituted, and

where other forms of integration and harmonization have been established). On the other hand, these countries will restrict trade with other non-members and impose trade barriers on goods coming from these countries.

8.9.4.1. Trade Barriers

Some of the most common trade barriers are:

(i) Tariffs

These are taxes levied on products that are traded across borders. However, governments impose tariffs essentially on imports and not on exports. Two most popular types of tariffs are:

- Ad valorem: This tariff involves a set percentage of the price of the imported goods.
- Specific: This refers to a specific amount charged by the government on import of goods.

(ii) Subsidies

Subsidies work to foster exports by providing financial assistance to locally-manufactured goods. Subsidies help to either sustain economic activities that face losses or reduce the net price of production.

(iii) Quotas

Import quotas are the trade limits set by the government to restrict the quantity of imports during a specified period of time.

(iv) Embargo

This is an extreme form of trade barrier. Embargoes prohibit imports from a particular country as a part of the foreign policy. In the modern world, embargoes are imposed during wartimes or due to severe failure of diplomatic relations.

(v) A voluntary export restraint

This is a restriction set by a government on the quantity of goods that can be exported out of a country during a specified period of time. Often the word voluntary is placed in quotes because these restraints are typically implemented upon the insistence of the importing nations.

8.9.4.2. Objectives of Regional Trade Policy

The main objectives of the regional trade policy are:

- To appreciate trade with other nations.

- To protect regional market prevailing in the region.

- To increase the export of particular products which would help in expanding the regional market.

- To prevent the imports of particular goods for giving protection to infant industries or developing key industry or saving foreign exchange, etc.

- To encourage the imports of capital goods for speeding up the economic development of the region.

- To restrict the imports of goods which create unfavourable balance of payments for the region.

- To assist or prevent the export or import of goods and services for achieving the desired rate of exchange.

- To enter into trade agreements with other nations for stabilizing the foreign trade.

Some nations make an attempt to protect their industries with trade policies which place a heavy burden on importers, allowing domestic producers of goods and services to get ahead in the market with lower prices or more availability. Others avoid trade barriers, promoting free trade, in which domestic producers are given no special treatment, and international producers are free to bring in their products. There are three proposed arguments offered as explanation for why a nation can adopt a certain trade policy or policies:

First is the **national defence theory**. According to this argument, certain industries such as weapons, aircraft, and petroleum are vital to a nation's defence. Therefore, proponents of this theory argue that these domestic industries should be protected from foreign competitors so that there is a domestic supply on hand in case of an international conflict. No country would like to be dependent on another country when it comes to weapons.

Second is the **infant industry theory**. Under this argument, it is believed that new domestic industries should be protected from foreign competition for so long so that they will have a chance to develop. Ideally, as the new industry matures and becomes able to stand on its own feet and compete effectively with other producers, the protection will be removed. It is intended to help a new domestic industry develop without being immediately crushed by already established foreign industries.

Last is the **antidumping theory**. Dumping is simply the selling of a good in a foreign country at a lower price than it is sold for in the domestic market. It is an illegal practice and current laws provide relief in the form of tariffs imposed against the violators. Proponents of this argument believe that if dumping is allowed, foreign producers will temporarily cut prices and drive domestic firms out of the market. Then they will use their monopoly to exploit consumers. Antidumping legislation is implemented to prevent this.

However, these types of trade restriction policies have certain disadvantages:

First is **Increased Cost to Consumers**: one of the most important disadvantages of trade restrictions is that it drives up the price of goods in a country where trade barriers artificially raise the price of imported products. The apparent effect of trade barriers is to prevent jobs from being lost to foreign competition, which is an argument used by many special interest groups to justify various types of trade barriers. In the long run, however, trade barriers force consumers to pay higher prices, since products that could otherwise be made cheaply overseas take more resources to produce domestically.

Second is **Increased Costs to Domestic Suppliers**: Price hikes due to trade barriers don't just affect consumers. It also puts a strain on firms which supply raw goods and commodities to domestic industries. Without trade barriers in place, such firms can rely on the law of comparative advantage, meaning that it would cost them more to try to find a certain raw material in their own country than it would to buy from a country rich in a particular commodity. Trade barriers artificially raise prices on foreign commodities, making it less profitable to buy from other countries.

Third is **Less Competition:** Trade barriers lessen foreign competition, leading to fewer product choices for consumers. The fact that trade restrictions make it more costly to purchase goods from abroad results in the domestic industry facing less competition from foreign markets. In the short term, this can save jobs in select domestic industries. However, in the long run, it leads to customers having fewer choices in the products they buy. It also gives producers less incentive to create high-quality products available to the public.

Fourth is **Escalations**: Over time, one country's policy of trade restrictions may lead to similar measures taken by foreign governments, who lose out in the international trade game because they can't export products for a profit. This cuts down on economic efficiency and competition on a global scale.

When nations trade with each other regularly, they often establish trade agreements. Trade agreements smooth the way for trading, spelling out the desires of both sides to create a stronger, more effective trading relationship. Many trade agreements are designed to accommodate a desire for free trade, with signatories to such agreements making certain concessions to each other to establish a good trading relationship. Regular meetings may also be held to discuss changes in the financial climate, and to make adjustments to trade policy accordingly.

Safety is sometimes an issue in trade policy. Different nations have different regulations about product safety, and when goods are imported into a country with stiff standards, representatives of that nation may demand the right to inspect the goods, to confirm that they conform to the product safety standards

which have been laid out. **Security** is also an issue, with nations wanting to protect themselves from potential threats while maintaining good foreign relations with frequent trading partners.

8.10.   Persons Involved in International Trade

This section describes the major players in international trade and the ways in which they provide or facilitate import finance.

8.10.1. International Trade Houses

The great majority of the world trade is carried out nowadays by private operators. International trade houses dominate, but brokers are also of some importance. Brokers are intermediaries remunerated on a commission basis by putting together a buyer and a seller. Although their role has markedly declined with the reduction of the number of intermediaries in the commercial chain, they still play a role, particularly in facilitating the operations of traders.

As well as purchasing goods in one place and selling them in another, international trade houses ensure their regrouping, storage, processing and transport (in particular maritime transport). Their operations are profitable not because of their logistical functions, but rather because of their overall management of trading positions (e.g. arbitrage between physical and futures markets). As part of their operations, they provide a wide array of financing solutions to their commercial counterparties. Their financing practices are not identical across commodities. For example, in the rice market, it is common for traders to carry the financing charges of the rice while it is being shipped to its final destination (which is in many cases not known at the moment that the rice is loaded). In contrast, traders tend to sell wheat, maize, soybean oil and palm oil before they are being loaded for export, with the effect that the buyer, not the trader, in effect carries the financing charges of the goods in transit.

Most of the large food trading enterprises are privately-held, and information on their operations can therefore be difficult to obtain.

8.10.2. Export State Trading Entities

The Uruguay Round Agreement defines State Trading Entities (STEs) as governmental and non-governmental enterprises, including marketing boards, which have been granted exclusive rights or privileges, including statutory or constitutional powers, in the exercise of which they influence, through their purchases or sales, the level or direction of imports or exports. In other words, STEs do not need to be state-owned.

8.10.3. Private Importers

The worldwide trend toward privatization has led to changes in buying habits. Private traders are now responsible for importing most goods. They tend to get little assistance from their own government in obtaining the funds for this. Most countries have now freed exchange controls, so hard currency is no longer centrally located, and importers have to procure it by themselves. In most cases, private traders are locally owned. The local, private traders may be fairly large in local terms, but tend to have limited experience and financial strength. They are generally diversified, importing the whole range of bulk commodities.

Even when imports are in private hands, the government still plays a large role. One example of this is Yemen, where imports are made through government tenders, which are open only to Yemeni private traders. The private traders do all the arranging for the imports, which are in turn sold to government-licensed distributors. Sales proceeds are turned over to the Ministry of Finance, which pays the importer a pre-negotiated fee for arranging the importation and sale of the commodities to the distributors.

8.10.4. State-owned Food Import Agencies

In some countries, particularly in North Africa, trade has been privatized, but the government retains an umbrella function over the imports of the key commodities

(cereals, sugar, vegetable oils), providing a certain amount of financing, imposing prices and giving subsidies.

Most of the state entities buy through public tendering, even if this is known to be an inefficient mechanism for food trade. For buying commodities which requires relatively quick decisions, public tendering is an inadequate purchasing method. If new suppliers participate in the bidding there is usually little time to check on the reliability and financial status of the firms and the risk exists that unreliable companies participate in the bidding. Bonds are no guarantee for performance of contracts if the loss on the bond is less than the profit which an unreliable company could make by selling the product in a bullish market. Non-performance of contracts is happening regularly in commodity markets, in particular at times when markets are volatile. Moreover, the long periods between the launching of tenders and the award of contracts affect the costs of the products. The longer those periods, the higher are the costs of bid bonds which suppliers have to provide. Given the delays inherent in the tender process, suppliers can be expected to build protection into their offered prices which may approximate several US dollars per ton.

8.10.5. Commercial Banks

Commercial banks in the exporting countries play a large role in the payment flows of international trade. They also provide a large part of the credit that enables the bulk imports by Less Developed Countries. One important way for them to provide such funding is through credit provided to international traders. Because international traders tend to leverage their own capital to a strong extent - their annual turnover may be 20 times or more as high as their capital - it is more appealing for banks to finance against the goods that the traders are handling rather than against the traders' balance sheet. There is a remarkable variety in the actual practices of commercial banks in this domain. It is useful to distinguish three parts of the trading cycle: pre-shipment; on the ship; and post-shipment.

- With respect to pre-shipment finance, traders in OECD countries can generally finance the goods they hold with little or no difficulty. Elsewhere, pre-shipment finance can be a problem unless the government arranges suitable facilities. The lack of pre-shipment finance is one of the major bottlenecks for the intra-African grain trade: it is difficult for local traders to obtain the credit needed to collect the goods destined for export.

- Once goods are charged onto a ship, finance can become difficult even for OECD origin countries. Many international banks are not willing to have any exposure to cargoes on high seas: they will provide pre-finance only if the goods are already sold, and a letter of credit (L/C) has been opened by acceptable foreign banks (which, in effect, means that their finance is against their available country and bank credit lines). In addition to this, they generally take consignment of the cargo under a non-negotiable bill of lading. In some cases, the bank may resort to a "repo financing", a mechanism in which the bank becomes the owner of the goods, with an option for the trader to buy them back once they arrive in the port of destination. In this case, the credit exposure does not count towards the trader's credit limit. Only a few banks engage in this business, because of the need to manage price risk, and then only with large international trading houses.

- Once the goods arrive, the financing burden is often entirely on the receiving country. The main exception is warehouse receipt finance; in which international traders extend their access to international finance into the country (banks generally increase their "margin", the share of the value of the goods that the trader has to cover himself/herself, to, for example, 15-20 percent). This still counts as country risk and corporate risk (towards the trader) for the international bank, which means that credit lines for such finance are limited by country and corporate credit lines.

8.10.6. Export Credit and Insurance Agencies, and Export-import Banks

All the large western countries support their agricultural exports through a mix of subsidies, export credits and export credit insurance. The ECAs (Export Credit Agencies) and EXIM (Export-Import) banks are export-promoting agencies run mainly by the government (but they can also be semi-governmental or private agency).

Export credits and export credit insurance have often been ways to provide hidden subsidies to exporters (although naturally, some governments claim they are merely commercial programs designed to overcome credit bottlenecks in export trade). Negotiations in the framework of the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO) have curtailed the possibilities of governments to give direct subsidies, which has made these indirect methods more important.

For the time being, the WTO agreement does not constrain export credit practices for agricultural products. Export credits for industrial products are regulated by the WTO Agreement on Subsidies and Countervailing Measures (SCM), which prohibits export subsidies, including subsidized interest rates and "the provision by governments... of export credit guarantee or insurance programs... at premium rates, which are inadequate to cover the long-term operating costs and losses of the programs".

Various credit insurance systems exist, and are summarized in Figures 8.9 – 8.11.
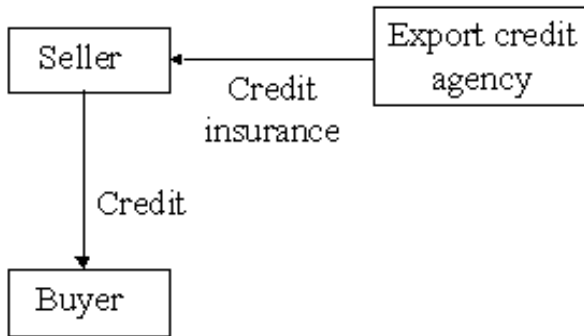
Figure 8.8: Credit Insurance

The simplest system (Figure 8.9) is that used by the United States in its PL480 program, where it gives a direct long-term credit at preferential rates to allow a foreign government to buy grains and other foodstuff in the US. The most prevalent system is that of export credit insurance, where an export credit agency (government-owned or private) covers the credit risk that a seller takes towards a buyer. In most cases, the credit insurance will cover both commercial and political risk; as a corollary to this, it is mostly available for sales to large, well-reputed buyers. Such credit insurance is provided by ECAs and EXIM banks in Australia, Brazil, Canada, France, Germany, Thailand and the United States. Where the ECA is a private entity, the government may re-insure it for certain large risks, if it feels the national commercial or political interest is at stake (there are such special re-insurance windows in Australia, France and Germany).

Another common system focuses on the seller's bank (Figure 8.10).

**Figure 8.9: Facilitating Bank Finance for the Exporter**
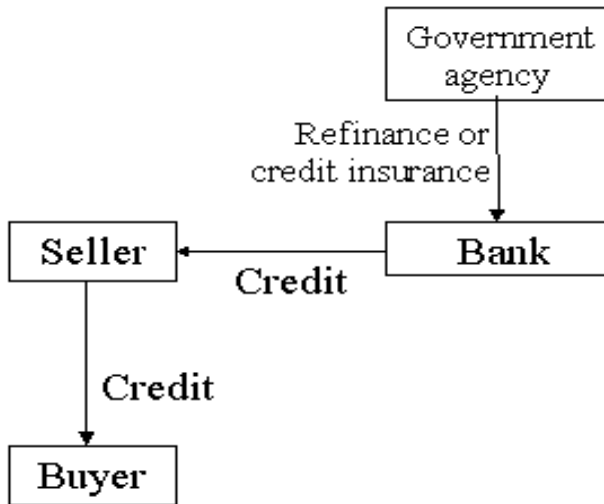
As in the previous scheme, the seller provides a credit, e.g. through a promissory note, to an overseas buyer. He/she does this under a credit line provided by his/her bank; the bank, in turn, can refinance itself cheaply with a government bank or can obtain credit risk coverage from a government agency. In these schemes, the seller retains a large credit risk vis-à-vis the buyer: he/she has to reimburse his/her bank for all or part of his/her credit if the buyer defaults.

In a third model (Figure 8.11), the credit scheme works through the buyer's bank. In this case, one or more banks in the importer's country are approved as credit counterparties under a scheme from the exporting country's government. These banks can obtain a credit line either from a commercial bank in the exporter's country or directly from the exporter's EXIM bank. In these schemes, the seller is paid on delivery by a bank in his/her own country, which will be reimbursed over a period of up to three years by an overseas bank. The overseas bank will be reimbursed by the buyer, over a period and at conditions that may or may not coincide with the conditions provided by the seller's bank. As the buyer's bank takes a credit risk vis-à-vis the buyer, he/she will normally ask for

collateral from the buyer (at times, even a 100 percent collateral, which in practice can make this model unattractive, or out of reach of most importers).

Figure 8.10: Working through the buyer's bank
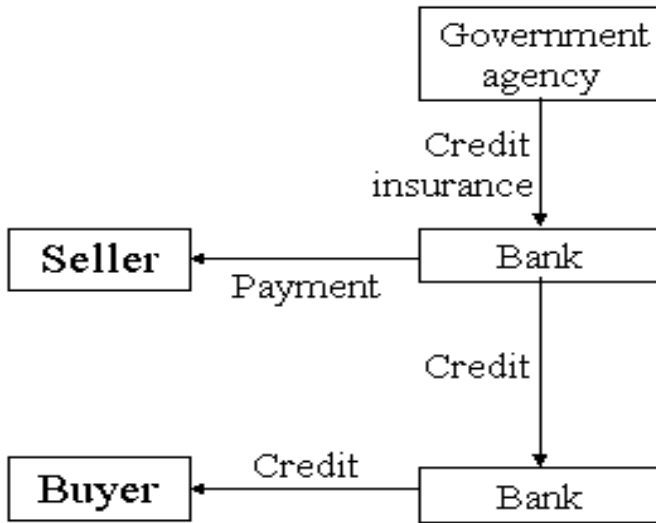
In practice, the schemes illustrated in Figure 8.11 require the importer to open an irrevocable hard currency letter of credit.

8.11. Main Steps and Documents in International Trade Transactions in Kenya

8.11.1. Licenses, Permits and Certificates

This section outlines some of the licenses, permits and certificates you are required to obtain to import or export goods.

8.11.1.1. Trade License

All importers and exporters must be licensed under the Trade Licensing Act, Cap 497. The licenses are issued by the respective District Trade Development Officers under the Ministry of Trade and Industry.

8.11.1.2. Exporter's Code Number

All businesses involved in exports are required to have a code number issued by the Customs Services Department. This is issued on presentation of a copy of either the Certificate of Incorporation or the Trade License or the Certificate of Registration of Business Name.

8.11.1.3. Import Licenses

Import licenses are generally not required except for a few items that are restricted for security, health or environmental reasons as detailed in the Imports, Exports and Essential Supplies Act (Cap 502).

8.11.1.4. Export Licenses

Export licenses are generally not required except in cases touching on public and food security; conservation of wildlife and natural resources and preservation of national heritage. The export licenses are issued by the Department of Internal Trade on production of authority or permit from the relevant government agency. Products requiring export licenses include military equipment, antiquities and works of art, wood-charcoal and timber, products related to endangered species such as rhino horns, and live animals other than livestock and domestic pets.

8.11.1.5. Product Specific Permits and Certificates

Some products require special permits and certificates before they can be imported or exported. The following are a few examples:

i) **Imports:**

1) Plants and plant products

- Plant Import Permit from Kenya Plant Health Inspectorate Services (KEPHIS)
- Phytosanitary Certificate from a competent authority in the exporting country

2) Drugs and Pharmaceuticals

- Import permit from Pharmacy and Poisons Board

3) Live animals

- Veterinary Import Permit from the Department of Veterinary Services, Ministry of Livestock and Fisheries Development
- Health Clearance Certificate

4) Used motor vehicles (originating from Japan and Dubai)

- Certificate of Roadworthiness

ii) Exports:

1) Fish (the following documents can be obtained from the Department of Fisheries)

- Processing license
- Fish movement permit
- Certificate of compliance with Kenya Bureau of Standards (KEBS) for fish handling and processing
- Export permit
- Health certificate

2) Plant and plant products

- Phytosanitary Certificate

3) Horticultural products require the following additional certificates and permits

- Export permit from Horticultural Crops Development Authority (HCDA)

- Compliance with traceability of produce, hygiene, maximum residue level (MRL), good agricultural practices (GAP) and proper post harvest handling procedures.

4) Mineral based products

- Permit from the Commissioner of Mines and Geology

8.11.2. Certificates of Origin

Certificates of Origin are issued by the Customs Services Department of KRA depending on the export destination. This certificate indicates the origin of the goods so that they can enjoy preferential treatment on entry into the export market, depending on the trade arrangement between Kenya and the importing country. The Kenya Bureau of Standards issues the Ordinary Certificate of Origin for countries listed in Table 8.61 below as well as to any other country at the request of the importer.

Table 8.61: Certificates of Origin

	Region/Countries	Source	Type of Certificate
1	COMESA Countries	KRA	COMESA Certificate of Origin
2	European Union	KRA	EUR-1 Form
3	USA, Japan, Australia, Canada	KRA	GSP Form
4	Middle East, India, Russia, Eastern and Central Europe	KEBS	Ordinary Certificate of Origin
5	AGOA	KRA	Textile Certificate of Origin

8.11.3. Sales Contract

In international trade, buyers and sellers are located in different countries, may speak different languages and have different laws. A sales contract is necessary to set out the terms of the sales transaction and guard against misunderstandings that could be costly to business.

A sales contract must include the following information:

- The parties involved i.e. the buyer and seller are identified
- The description of the goods being sold

- The quantity of the goods e.g. kilograms, liters

- The price of the goods in the agreed currency

- The delivery terms

- The payment terms

- Other information that could be included is:

- The duration of the contract

- The obligations of the seller and buyer

- Dispute settlement procedures

- Definitions and interpretations within the context of the contract

8.11.4. Financial Transactions

Financial arrangements for imports and/or exports are normally more complex that those for domestic trade. Most of the payments are upfront and therefore you need to determine the funds you require and make adequate arrangements for sourcing these funds. You will make payments and/or receive proceeds in foreign currency. International banks will be involved. The exchange rates may fluctuate and, in the process, you may receive less proceeds than you expected or be required to pay more than originally planned.

The next section explains what you need to do to ensure that payments and receipts are handled well.

8.11.4.1. Preparing for Import Payments

8.11.4.1.1. Ensure you have a Bank Account

You will need to use a bank account to make payments. Open a bank account with one of the reputable banks. It is advisable to use a large bank because it will have a worldwide network and is likely to have better experience. It is also likely to be less costly. If you import regularly from a particular country, it may be advisable to maintain a foreign currency bank account.

8.11.4.1.2. Ensure Adequate Funds

Payment for imports is likely to be required upfront. You need to determine the total cash outlay you require for each import transaction. The cost components are:

- Purchase price
- Freight
- Insurance
- Customs duty and taxes
- Port charges
- Local transport
- Clearing agent fee
- Bank charges

8.11.4.1.3. Agree on the Mode of Payment

There are three modes of payment that you can use:

i) Irrevocable Documentary Credit

This is the most frequently used method for paying for imports and also one of the costliest. It is irrevocable because it cannot be amended or cancelled without the agreement of all the parties concerned. It is considered the most secure because the buyer is assured that the seller will only be paid when the goods have been delivered. The seller is also assured that the buyer will obtain the goods only when payment has been made. The security of the transaction is assured by the buyer's bank, which issues the letter of credit specifying the conditions to be fulfilled before payment is released, and the seller's bank, which informs the seller that the Letter of Credit (L/C) has been issued and may guarantee it. When the seller has fulfilled all the conditions set out in the L/C, she/he submits the appropriate shipping documents to the bank and collects payment.

ii) Open Account

This method does not provide security to the exporter but is cheaper as banking and other costs are avoided. The exporter sends the shipping and other documents to the buyer personally. The buyer then pays the exporter by bank transfer on receipt or after an agreed period, if credit is provided.

iii) Documentary Collection

This is also called *cash against documents* (CAD). The shipping documents are handed over to the exporter's bank for forwarding to the buyer's bank, with instructions to release them to the buyer on payment of the exporter's invoice. If the exporter has provided credit to the buyer, then she/he can draw a bill of exchange on them requiring them to accept the bill when they collect their documents. This is called *documents against acceptance* (DAA)

iv) Cash-in-advance

Where the exporter is unsure about the buyer's credit worthiness or ability to pay, she/he can ask for cash in advance.

8.11.4.1.4.   Agree on the Currency

Selecting the currency in which you transact is important because some currencies fluctuate more frequently than others. The most commonly used currency is the US Dollar. However, companies in some countries, such as the UK, Germany, France, the UAE and Japan may require that you use their currencies. Try to use a currency that is likely to be stable.

8.11.4.1.5.   Seek Advice from your Bank

Before you conclude the mode of payment with the supplier, obtain advice from your bank. Bankers have experience in handling import payments and will assist in risk assessment. This may reduce costs incurred in making foreign payments.

8.11.4.1.6. Negotiate with the Bank when Buying Foreign Currency

Some banks will give you better than posted buying rates especially when the payment is large. Negotiate for a better rate with your manager before payment.

8.11.4.2. Preparing for Export Payments

8.11.4.2.1. Ensure you have a Bank Account

As discussed above, ensure that you have an account with a reputable bank. If you will be a regular exporter you should open a foreign currency bank account. This may save on the time and cost involved in foreign currency conversion.

8.11.4.2.2. Ensure Adequate Funds

Just as in imports, you will need funds to prepare for your exports. Determine the amount of funds required and set the funds aside. The cost of an export will constitute:

- Raw materials
- Cost of production, packaging and labeling
- Transport to port of exit
- Insurance to port of exit
- Freight
- Customs duty and taxes
- Freight forwarder fee
- Port charges

8.11.4.2.3. Agree on the Mode of Payment

As an exporter you should use an irrevocable letter of credit because it is guaranteed by a bank. However, your customer may request you to consider other modes of payments. You need to consider the credibility of the buyer before you decide on any other mode.

8.12.   International Commercial Terms (INCOTerms)

INCOTERMS (INternational COmmercial Terms) 2000, published by the International Chamber of Commerce (2000 pub 560), are the most commonly accepted terms of sale.

INCOTERMS Provide an Internationally accepted definition of:

- The responsibility of the Buyer and Seller.

- The allocation of costs.

- The assumption of risks.

- Have been created to adapt to the most contemporary commercial practices

However, they do not

- Dictate the contract of carriage.

- Include all of the duties of the buyer / seller in a transaction.

- Deal with a breach in contracts ,

- Deal with Exemptions from Liability in case of impediments.

- Do not speak about payments between Buyer / Seller.

8.12.1. EXW (Ex Works…named place)

Ex Works means that the seller fulfils his obligation to deliver when he has made the goods available at his premises or another named place (i.e., works, factory, warehouse, etc.) to the buyer, suitably packed for export. In particular, he is not responsible for loading the goods on a vehicle provided by the buyer or for cleaning the goods for export. This term thus represent the minimum obligation for the seller, and the buyer has to bear all cost and risks involved in taking the goods from the seller's premises. If the parties wish the seller to be responsible for the loading of the goods on departure and its risks and costs, this should be made clear by adding explicit wording to this effect in the contract of sale. This term should not be used when the buyer cannot carry out the export formalities

directly or indirectly. In such circumstances, the FCA term should be used, provided the seller agrees that he will load at his cost and risk.

8.12.2. FCA (Free Carrier…named place)

This term has been designed to meet the requirements of modern transport, particularly such "multi-modal" transport of container or "roll on-roll off" traffic trailers and ferries. It is based on the same main principle as FOB except that the seller fulfils his/her obligations when he/she delivers the goods into the custody of the carrier at the named point. If no precise point can be mentioned at the time of the contract of sale, the parties should refer to the place or range where the carrier should take the goods into his/her charge. The risk of loss or damage to the goods is transferred from seller to buyer at that time and not at the ship's rail. A "Received for Shipment" Bill of Landing is acceptable in lieu of an "On Board" Bill of Landing. This allows exporters to receive shipping documents more quickly and to get paid in a more timely manner. "Carrier" means any person by whom or in whose name a contract of carriage by road, rail, air, sea or a combination of modes has been made. When the seller has to furnish a bill, waybill or carrier's receipt, he/she duly fulfils this obligation by presenting such a document issued by a person so defined. The seller is responsible for clearing the goods for export.

8.12.3. FAS (Free alongside Ship…named port of shipment)

This means that the seller fulfils his obligation to deliver when the goods have been placed alongside the vessel at the named port of shipment. The buyer has to bear all costs and risks of loss or damage to the goods from that moment. The FAS term requires the seller to clear the goods for export.

8.12.4. FOB (Free on Board…named port of shipment)

This means that the seller fulfils his obligation when the goods are placed on board a ship by the seller at a port of shipment named in the sales contract. The risk of loss or damage to the goods is transferred from the seller to the buyer when the goods pass the ship's rail. All costs from that point forward, including

freight and insurance, are for the buyer's account. This term requires the seller to arrange export clearance. This term can be used only for sea or inland waterway transport. If the parties do not intend to deliver the goods across the ship's rail, the FCA term should be used.

8.12.5. CFR (Cost and Freight…named point of destination)

The seller must pay the cost and freight necessary to bring the goods to the named destination, but the risk of loss or damage to the goods, as well as any additional costs due to events occurring after the time of delivery, are transferred from the seller to the buyer when the goods pass the ship's rail in the port of shipment. The CFR term requires the seller to clear the goods for export. This term should only be used for sea and inland waterway transportation. If the parties do not intend to deliver the goods across the ship's rail, the CPT term should be used.

8.12.6. CIF (Cost, Insurance and Freight…named port of destination)

This means that the seller delivers when the goods pass the ship's rail in the port of shipment. The seller must pay the costs and freight necessary to bring the goods to the named port of destination but the risk of loss or damage, as well as additional costs due to events occurring after the time of delivery are transferred from the seller to the buyer. In CIF the seller also has to procure marine insurance against the buyer's risk of loss or damage to the goods during the carriage. Consequently, the seller contracts for insurance and pays the premium. The buyer should note that under the CIF the seller is required to obtain insurance only on minimum cover. The CIF term requires the seller to clear the goods for export. This term should be used only for sea and inland waterway transport. If the parties do not intend to deliver the merchandise across the ship's rail, the CIP term should be used.

8.12.7. CPT (Carriage Paid to…named place of destination)

This term means that the seller delivers the goods to the carriage nominated by him, but the seller must also pay the cost of carriage to bring the goods to the

named destination. Like CFR, the buyer bear all risks and any other costs occurring after the goods have been so delivered. "Carrier" is defined as any person who, in a contract of carriage, undertakes to perform or to procure the performance of transport, by rail, road, sea, inland waterway or by a combination of methods. If subsequent carriers are used for the carriage to the agreed destination, the risk passes when the goods have been delivered to the first carrier. This CPT term requires the seller to clear the goods for export.

8.12.8. CIP (Carriage and Insurance Paid to… named place of destination)

This term is the same as "Carriage Paid to…" but with the addition that the seller has to procure insurance against the risk of loss or damage to the goods during the carriage. The seller contracts with the insurer and pays the insurance premium. CIF is used for goods carried by sea, while CIP is used irrespective of the mode of transport. This term allows the exporter the greatest control over all aspects of shipment.

8.12.9. DAF (Delivered at Frontier…named place)

This term is used typically when goods are being moved overland, and delivery of the goods will take place at the frontier of an adjoining country. It means that the seller delivers when the goods are placed at the disposal of the buyer on the arriving means of transport not unloaded, cleared for export, but not cleared for import at the named point and place at the frontier, but before the customs border at the adjoining country. The frontier must be clearly named. For example, goods being shipped from the U.S. to Mexico might have Laredo, Texas, named as the frontier. The shipper has the responsibility of delivering the goods to Laredo, while the buyer has the responsibility to bring the goods across the border into Mexico and clear Mexican customs. This term may be used irrespective of the mode of transport when goods are to be delivered at a land frontier. When delivery is to take place in the port of destination, on board a vessel or on the wharf, the DES or DEQ terms should be used.

8.12.10.   DES (Delivered Ex-Ship…named port of destination)

This term means that the seller delivers when the goods are placed at the disposal of the buyer on board the ship, not cleared for import at the named port of destination. The seller must bear all the costs and risks involved in bringing the goods to the named port of destination before discharging. If the parties wish the seller to bear the costs and risks of discharging the goods, then the DEQ term should be used. This term can be used only when the goods are to be delivered by sea or inland waterway or multimodal transport on a vessel in the port of destination.

8.12.11.   DEQ (Delivered Ex-Quay…named port of destination)

This term means that the seller delivers when the goods are placed at the disposal of the buyer not cleared for import on the quay at the named port of destination. The seller bears costs and risks involved in bringing the goods to the named port of destination and discharging the goods on the quay. The DEQ term requires the buyer to clear the goods for import and to pay for all formalities, duties, taxes and other charges upon import. This term can be used only when the goods are to be delivered by sea or inland waterway or multimodal transport on discharging from a vessel onto the quay at the port of destination. If the parties wish to include in the seller's obligation the risks and costs of the handling of the goods from the quay to another place (warehouse, terminal, transport station) in or outside the port, the DDU or DDP terms should be used.

8.12.12.   DDU (Delivered Duty Unpaid…named place of destination)

This term means that the seller delivers the goods to the buyer, not cleared for import, and not unloaded for any arriving means of transport at the named place of destination. The seller has to bear the full cost and risk involved in bringing the goods thereto other than, where applicable, any "duty" (which includes the responsibility for and the risk of the carrying out of customs formalities, and payment of formalities, custom duties, taxes and other charges)

for import in the country of destination. Such "duty" has to be borne by the buyer as well as any costs and risks caused by his failure to clear the goods for import in time. This term may be used irrespective of the mode of transportation, but when delivery is to take place in the port of destination on board the vessel or on the quay, the DES or DEQ terms should be used.

8.12.13. DDP (Delivered Duty Paid…named place of destination)

This term means that the seller delivers the goods to the buyer, cleared for import, and not unloaded from any arriving means of transport at the named place of destination. The seller must bear all costs and risks involved in bringing the goods thereto including, where applicable, any "duty" (which includes the responsibility for and the risk of carrying out of custom formalities, custom duties, taxes and other charges) for import in the country of destination. While the term EXW signifies the seller's minimum obligation, the DDP term represents the maximum obligation. If the parties wish the buyer to bear all the risks and costs of the import, the DDU term must be used. The DDP term may be used irrespective of the mode of transport but when delivery is to take place in the port of destination on board the vessel or on the quay, the DES or DEQ terms should be used.

8.13. International Forms and Methods Of Payment

International trade presents a spectrum of risk, causing uncertainty over the timing of payments between the exporter (seller) and importer (foreign buyer).

To exporters, any sale is a gift until payment is received.

Therefore, the exporter wants payment as soon as possible, preferably as soon as an order is placed or before the goods are sent to the importer.

To importers, any payment is a donation until the goods are received.

Therefore, the importer wants to receive the goods as soon as possible, and cab delay payment as long as possible, preferably until after the goods are resold to generate enough income to make payment to the exporter.

The most common ways international business payments are done are:

8.13.1. Payment In Advance: Payment occurs: Before Shipment

This is usually done via international wire transfer from one bank account to another or bank-to-bank wire transfer (regarded as safer). It takes a few hours to a few days. Alternatively, it can be done with a credit card or telegraphic transfer. Note that it is possible for an imposter to collect payment at telegraphic transfer offices, and documentation via that method is limited.

Cheque clearing time can be as long as two months, so cheques are not commonly   used.
Even within one country, paying in advance requires great trust that the seller will deliver honestly and on time. When someone does not honour their portion of an international deal, trying to make them come through is complicated by having multiple legal systems involved. If you pay in advance internationally, you need to be *absolutely sure* the seller will deliver.

This method is highly insecure for buyers, but very comfortable for sellers. Payment transfer services incur fees.

8.13.2. Documentary Letter of Credit: Confirmed or Unconfirmed - Sight, Date or Time

This comes in a variety of forms:

- confirmed - sight

- confirmed - date or time

- unconfirmed - sight

- unconfirmed - date or time

A letter of credit is a bank-to-bank guarantee to pay the seller (beneficiary) upon presentation of specific documents that comply with terms set by the buyer (applicant). The documents convey title to goods by showing that specific steps

have been taken, or as of a maturity date, or a designated period of time after an event. Terms of payment must be specified clearly and completely to avoid confusion and delay.

International Chamber of Commerce (ICC) publishes "Uniform Customs and Practices" (document number UCP600) to govern letters of credit. Worldwide, over 90% of banks honour these rules. There are revocable and irrevocable letters of credit, although UCP600 only accommodates irrevocable (terms and conditions can only be changed with explicit consent from all parties). If unconfirmed, the payment guarantee is by the buyer's bank, and the letter of credit must be irrevocable. If confirmed, the guarantee is by the seller's bank.

Banks charge a percentage of the transaction amount as their fee, which is usually but not always paid by the buyer. If fees are charged by both banks in the transaction, price quotes and the letter of credit should specify which party pays each fee.

Sellers tend to like letters of credit as a secure way to get paid. Buyers tend to be less keen about this because of the expense (typically one to eight percent) and processing can take up to a month, delaying order delivery. As parties become more comfortable dealing with each other, payment is likely to change to less expensive payment methods such as drafts.

8.13.2.1.   Confirmed - Sight

Payment occurs: Typically linked to time of shipment.

Example clause: "£12,000 British pounds sterling net 15 days from shipment."

Seller has risk with the confirming bank and documentary risk. Buyer must trust seller to make certain goods are delivered after payment is transferred.

8.13.2.2.   Confirmed - Date or Time

Payment occurs: At maturity.

Example: "$21,000 US net 15 days from acceptance."

Seller has risk with the confirming bank and documentary risk. Buyer must trust seller to make certain goods are delivered after payment is transferred.

8.13.2.3. Unconfirmed - Sight

Payment occurs: Typically linked to time of shipment.

Example clause: "25,000 Euros net 15 days from shipment."

Buyer has assurance that shipment occurs, but must trust seller to ship the goods described in the document.

8.13.2.4. Unconfirmed - Date or Time

Payment occurs: At maturity.

Example clause: "150,000 Japanese yen net 15 days from acceptance."

Seller has risk with the issuing bank and documentary risk. Buyer has assurance that shipment occurs, but must trust seller to ship the goods described in the document.

8.13.3. Documentary Draft (bill of exchange): Against Payment - Sight or Against Acceptance - Date or Time

This comes in a couple of forms:

- against payment - sight

- against acceptance - date or time

A *draft* is like a foreign buyer's check. As with a domestic cheque, there is a risk that it might not clear. It differs from a domestic cheque in that title does not transfer to the buyer until the draft is paid (or at least legal steps are taken to ensure that it will be paid when it is due).

Documentary drafts fall under the category *bills for collection*. In some markets (particularly in Asia), these methods are favoured as a cost-effective way to satisfy Exchange Control Regulations. ICC publishes "Uniform Rules for Collections" (document number URC522) to govern these. Worldwide, over 90% of banks honour these rules.

The documentation requesting payment is sent from seller's bank to buyer's bank, instead of directly from seller to buyer. The banks can sometimes help resolve any disputes that arise and threaten to disrupt the transaction. If the buyer fails to meet conditions specified in the documents, in some situations the seller can keep title to the shipment and may be able to recover the goods.

Drafts are often used when buyer and seller regard each other as trustworthy, there is no doubt about the buyer's ability and willingness to pay, no constraining foreign exchange controls need to be dealt with, and the buyer is in a politically and economically stable nation.

Against Payment – Sight

Payment occurs: When draft is presented to buyer (often a verbal notification). With a sight draft, the seller keeps title for the goods until they reach their destination and payment occurs. If shipment is by sea, the ocean bill of lading is endorsed by the seller. Then the seller's bank sends it to the buyer's bank, along with the sight draft and supporting documents such as invoices, consular invoices, certificates of insurance or packing lists. The buyer is notified when these documents arrive. When the draft is paid, the bank turns over the bill of lading so the buyer can claim the shipment. (Air bills of lading and railway or road transport have less rigorous requirements before the buyer can take the shipment. Therefore, a sight draft involves more risk if shipment is not by sea.) The buyer can have a change of mind between the time when the goods are shipped and the time when the draft is presented for payment. If this happens, the bank is not obligated to pay. Similarly, the bank is not obligated to pay when governmental policies change and interfere with delivery. If such problems

lead to the buyer not paying for or not receiving the shipment, the seller is stuck with the problem of what to do with the goods.

Against Acceptance - Date or Time

Payment occurs: At maturity. A date draft stipulates a date on which payment is due. A time draft stipulates that payment is due by a specific amount of time after the buyer accepts the time draft and receives the shipment, such as "20 days after acceptance." (When the buyer writes "accepted" on the draft that is trade acceptance.)

8.13.4. Open Account: Payment occurs: As agreed.

Goods are shipped. Seller sends a bill to buyer and buyer is expected to pay under agreed firms. This is much like having an open account for a customer within the States. Some large companies will only buy this way. There are markets, notably Europe, where buyers often expect Open Account. However, open account is appropriate only when the buyer has a long, good record as a payer and is definitely creditworthy. Open account can be thought of as meaning "open to risk." The ongoing nature of an open account raises the odds that political or economic situations may deteriorate. Legal enforcement to collect payment may be hindered because the extensive documents and banking involvements of other methods are missing--not to mention that pursuing collections abroad tends to be expensive and difficult. Factoring or export credit insurance may be advisable to reduce risk. This is highly insecure for sellers, but very comfortable for buyers.

8.13.5. Standby Letter of Credit: Payment occurs: If necessary.

This is a bank guarantee of payment that is triggered only if the buyer fails to pay in the normal manner, such as defaulting on payments due under Open Account. Note that this lacks the documentary controls in Letters of Credit.

8.13.6. International Countertrade: Payment occurs: Variable.

One party accepts goods, services, or something else other than money as partial or complete payment. Beyond that vague description, there are many variations. Most forms of countertrade can be thought of as forms of barter. However, direct barter is not common internationally. The two parties rarely have balanced needs for each other's products, and agreeing upon the value of goods may be difficult. To get around that, the parties can trade through an intermediary. (There are brokers and export management companies that handle such transactions.) Transaction cost and risk are often higher than with other types of international transactions. However, countertrade may be the only way to do business with a company that does not have access to foreign exchange or is in a nation whose currency is not readily exchangeable.

8.13.7. Consignment Sales: Payment occurs: After sale of goods.

On the surface, this looks like consignment sales within the States. The seller sends goods to a distributor in another country, and the distributor sells them on behalf of the seller. The seller keeps title to the goods until they are sold, after which the distributor pays the seller. Despite legally having title until goods are sold by the distributor, the exporting seller has considerable risk: practically no control over the merchandise, and delay before payment arrives. Appropriate insurance is highly advisable, including property coverage over the goods until they are sold and payment occurs.

8.13.8. Escrow: Payment occurs: As agreed, typically after acceptance.

Buyer deposits funds, property or other tangibles in an escrow account that is supervised by an escrow agent (a neutral third party trusted by both buyer and seller). When the terms of the escrow agreement are met (such as satisfactory delivery of goods to the buyer), the escrow agent releases the funds to the seller.

This mechanism is low risk for both buyer and seller if a reputable escrow agent

is used. However, it adds cost (the escrow agent's fee), takes time to set up, and can be difficult to set up internationally. It is normally only used for large transactions. Caution against fraudulent escrow agents is advised.

8.14.   Remittances and Settlements

International money transactions refer to the movement of funds from one country to another. The main reason for moving funds from one country to another is the settlement of debts resulting from international trade.

The methods of payment chiefly include remittance, collection and L/C. If the payment is made by remittance, it is called favorable exchange, by which the buyer makes the payment by bank of his own accord; if by collection or L/C it is adverse exchange, by which the exporter takes the initiative to gather payment from the buyer.

To choose a method for the payment of the goods, you should consider the credit standing of the buyer. Different methods of payment mean different credits. Bank credit is more reliable than commercial credit. So, we should choose the right method for the safe settlement of the payment.

8.14.1. Remittance

Remittance is to deliver the payment of the goods to the seller by bank transfer. In remittance, there are four parties involved: the remitter, the beneficiary, the remitting bank and the paying bank.

The remitter remits the money to the beneficiary as it is required by the contract concluded between them. And when the remitter comes to the remitting bank, he fills an application form for the bank to effect the payment, which upon remittance will be binding upon the remitting bank. And the paying bank pays the beneficiary because it is the branch bank or correspondent bank of the remitting bank in the country of the seller.

Remittance is mainly used for payment in advance, open account for small quantity of goods, commission, sundry charges, etc.

If it is used for payment in advance or cash with order, it will place the seller in an advantageous position.

If for delivery first and payment afterwards, it will place the buyer in a favorable position.

It is important to note that remittance uses commercial credit and hence in adopting this method, the parties involved need have trust in each other.

8.14.2. Types of Remittance

Money transfer can be channeled through banks by mail transfer (MT), telegraphic transfer (TT), and demand draft (DD).

(a) By mail transfer, the buyer will hand over the payment of the goods to the remitting bank that will authorize its branch bank or correspondent bank in the country of the beneficiary by mail to make payment to him.

(b) By telegraphic transfer, the buyer will hand over the payment of the goods to the remitting bank which will authorize its branch bank or correspondent bank in the country of the beneficiary by telegraphic means to make the payment to him. Mail transfer is cheap but time-consuming, while telegraphic transfer is more expensive but much faster.

These two methods are shown in Figure 8.11 below.
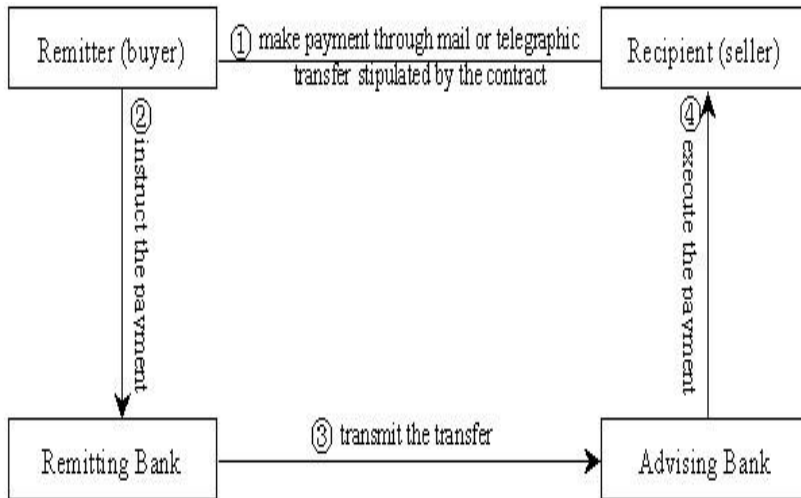
Visual Presentation of Remittance by Mail and Telegraphic Transfer

Figure 8.11: Remittance by Mail and Telegraphic Transfer

(c) By demand draft, the buyer will come to the local bank to buy a banker's bill and then deliver it to the seller or beneficiary by mail. When the seller of beneficiary receives it, he will come to the bank designated by the banker's bill for cash. This method is shownn in Figure 8.12 below.
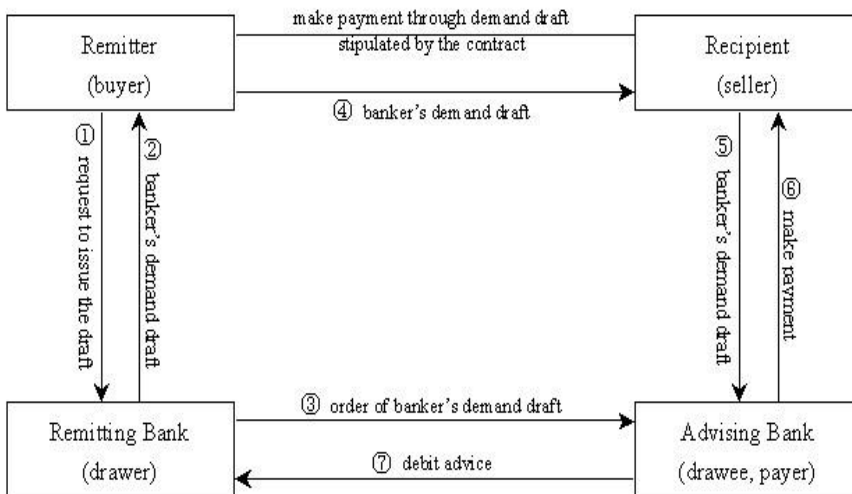
Visual Presentation of Remittance by Demand Draft

Figure 8.12: Remittance by Demand Draft

8.14.3. Collection

Under collection, the exporter takes the initiative to collect the payment from the buyer. Upon the

delivery of the goods, the exporter draws a bill of exchange on the importer for the sum due, with or without relevant shipping documents attached, and authorizes his bank to effect the collection of the payment through its branch bank or correspondent bank in the country of importer.

Collection can be of either documentary collection or clean collection. Documentary collection has the relevant shipping documents attached to the draft, while in clean collection only draft is used.

Documentary collection is most often used in the payment of goods in international trade while clean collection is occasionally used in the payment of balance, extra charges, etc.

Collection uses a commercial credit, and the banks involved do not bear any risk if the payment of the goods is not made by the buyer. So before adopting this method, the seller should be sure that the buyer is reliable and be able to make the payment.

Parties Involved in Collection

      (a) The Principal (exporter or seller)

      (b) The remitting bank (A bank at the place of the seller)

      (c) The collecting bank (correspondent or branch of the remitting bank)

      (d) Drawee (buyer or importer)

The Principal is the person who draws the bill of exchange and authorizes his bank to effect the collection.

The remitting bank is the bank that is authorized by the drawer of the draft to effect collection from the buyer. It is usually the bank at the place of the seller.)

The collecting bank is the bank authorized by the remitting bank to collect the payment from the drawee, or the buyer of the goods. Usually this is the bank in the country of the buyer.)

The drawee is usually the buyer of the goods who should make payments in time.)

### 8.14.4. Documents against Payment (D/P)

Under D/P, the buyer can receive the shipping documents only after he has duly made the payment of the goods. It can be of 2 types: D/P at sight and D/P at days after sight (date).

- **D/P at sight.** Under D/P at sight, the seller might draw a draft on the buyer. He hands over the shipping documents together with draft, and the shipping documents and the draft will be transferred to the collecting bank which present them to the buyer and ask him to make the payment

at sight. The buyer, upon sight, should then make the payment and obtain the shipping documents. When the collecting bank has finished the collection, it should immediately notify the remitting bank, which will then make the payment to the seller.

This is shown in Figure 7 below.

Figure 8.13: D/P at Sight

Visual Presentation of D/P at sight
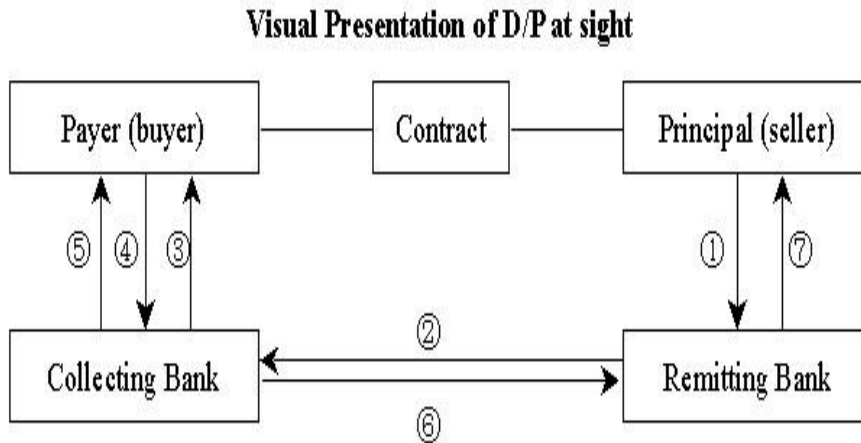
- **D/P at days after sight (date).** Under D/P at days after sight (date), the buyer shall duly accept the documentary draft drawn by seller at days' sight upon first presentation and make payment on its maturity. The shipping documents are to be delivered against payment only.

This is shown in Figure 8.14 below.

Visual Presentation of D/P after sight


```
┌──────────────┐         ┌──────────┐         ┌─────────────────┐
│ Payer (buyer)│─────────│ Contract │─────────│Principal (seller)│
└──────────────┘         └──────────┘         └─────────────────┘
      ▲  │  ▲                                        ▲   │
     ⑤ ④ ③                                          ① ⑦
      │  ▼  │                  ②                     ▼   │
┌──────────────┐         ◄──────────────        ┌─────────────────┐
│Collecting Bank│                        ───────►│ Remitting Bank  │
└──────────────┘                 ⑥              └─────────────────┘
```
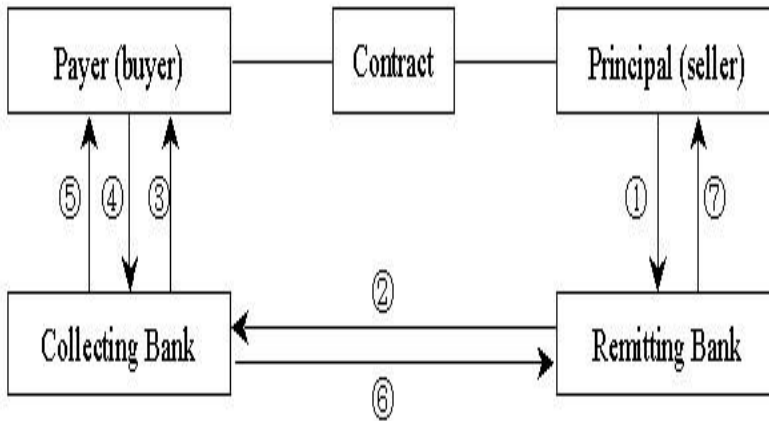
Figure 8.14: D/P after Sight

Under D/P, the buyer cannot obtain the shipping documents if he does not make the payment, should this happen, the seller need first negotiate with the buyer, and at the same time, he may consider if he can sell the goods to others or to ship the goods back, usually at his own cost.

8.14.5. Documents Against Acceptance (D/A)

Under the D/A, the buyer can get the shipping documents from the collecting bank after he has duly accepted the draft. This is only applicable to time draft. This is greatly convenient to the buyer, but it means much more risk for the seller, for once he has delivered the shipping documents, he will have lost his title over the goods.

 D/A means more risks for the seller, for the buyer might refuse to pay after he has accepted the draft and taken the delivery of the goods. Certainly the seller might sue the buyer, but as is often the case, the buyer claims bankruptcy and

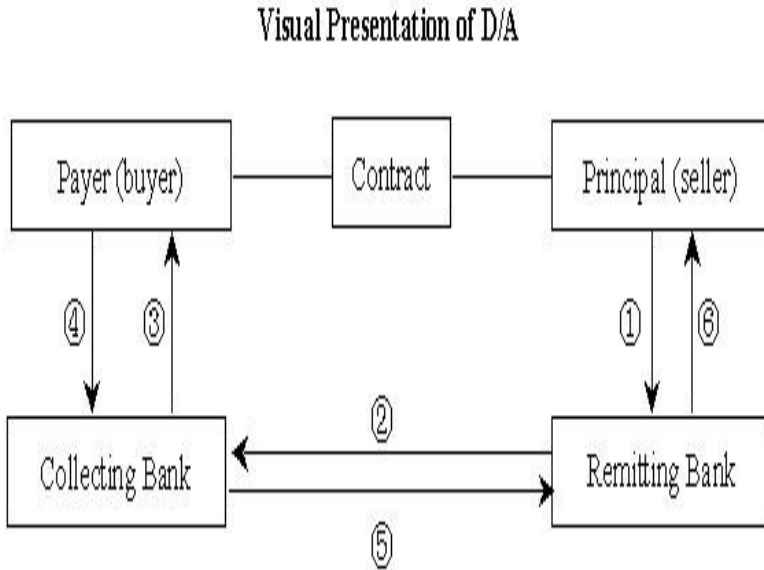then the seller can do nothing to remedy the situation. D/A is shown in Figure 8.15 below.

Visual Presentation of D/A

Figure 8.15: Documents against Acceptance (D/A)

8.14.6. Letter of Credit (L/C)

As we can see, neither remittance nor collection is a safe means for the settlement of payment in international trade as both of them rely on commercial credit. With the development of international trade, bank credit gets involved in the settlement of payment which provides it with more secure means. L/C is the major means thus developed and is now most often used in the settlement of payment in international trade.

In international trade practice, a L/C can be seen as a document by which a bank, upon the request of an importer, promises to effect the payment of the goods to the exporter.

8.14.6.1.   Function of L/C:

The L/C solves the possible problems arising from the distrust between the seller and the buyer. Under L/C, the seller can feel assured that so long as he has made the delivery of the goods and got the required documents he can get the payment of the goods in time and the buyer can also feel at ease that he can get the shipping documents at the same time when he effects the payment of the goods.

8.14.6.2.   Parties Involved in L/C

- **The applicant**, who is usually the importer that applies to the bank for the L/C.
- **Issuing bank**, which opens the L/C upon the request of the importer.
- **Advising bank**, or notifying bank, is authorized by the issuing bank to transfer the L/C to the exporter's bank.
- **Beneficiary**, who is usually the exporter and is entitled to use the L/C for the payment of the goods.
- **Negotiating bank**, which is willing to buy on discount the documentary draft drawn by the beneficiary.
- **Paying bank** is designated by the L/C to pay the draft.
- **Confirming bank** is asked by the issuing bank to confirm the L/C. If a bank has confirmed the L/C, it holds itself responsible for the negotiation or payment of the L/C.

8.14.6.3.   The Main Contents of L/C

a) The parties involved, including the applicant, the issuing bank, negotiating bank, the paying bank, etc.
b) Remarks about the L/C: such as the No. of the L/C, its type, the issuing date, etc.
c) The amount of the L/C
d) The clauses of the bill of exchange, such as the amount of the bill, drawer and drawee, the paying date, etc.

e) The clauses about the documents, what documents are required, such as the invoice, the bill of lading, the insurance policy, the packing list, the certificate of origin, and inspection certificate, etc. Also, the required number of copies of the documents, description of the goods, specifications, quantity, packing, unit price, total amount, mode of transport, place of unloading, etc.

f) Particular clauses, such as the special provisions about the deal in accordance with the particular business or political situations of the importing country.

g) Guarantee clauses of the issuing bank, which testifies that the issuing bank will hold itself responsible for the payment to the beneficiary or the holder of the draft.

8.14.6.4.   Revocable L/C and Irrevocable L/C

Revocable L/C is the one that can be withdrawn or amended by the issuing bank any time before the negotiation, or acceptance, or before payment is effected. In doing so, the issuing bank does not need to have the agreement or even notify the beneficiary. This is rarely used in the settlement of payment in international trade.

Irrevocable L/C is the one that cannot be withdrawn or amended by the opening bank without the agreement of the beneficiary. This kind of L/C is more secure and hence is most often used.

We should note that, according to Uniform Customs and Practice of Commercial Documentary Credits 500, if a L/C is not marked as being irrevocable, it should be taken as irrevocable.

8.14.6.5.   The Procedures Involved in the Use of L/C

The procedure involved in the use of a letter of credit is shown in Figure 8.16 below.

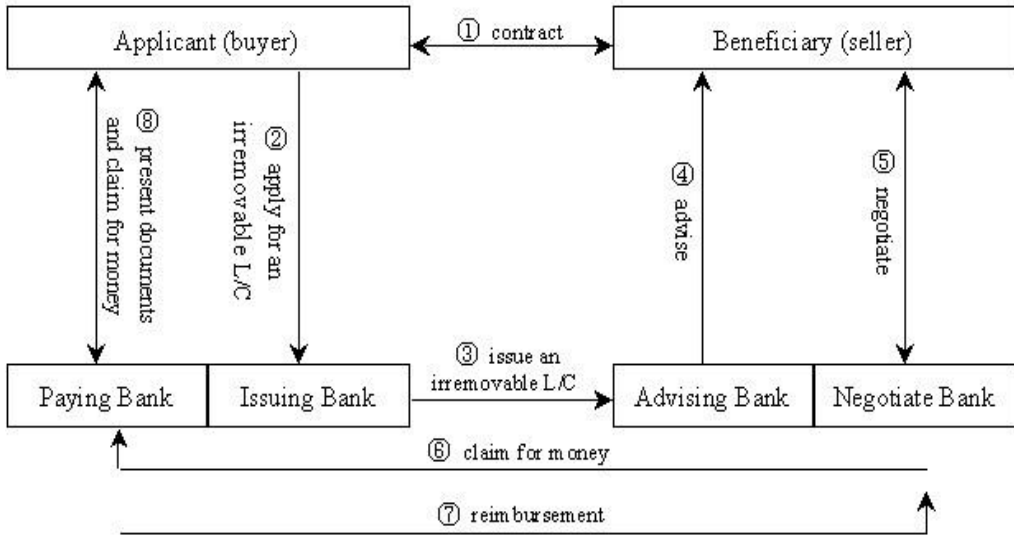**Visual Presentation of an irremovable L/C**

Figure 8.16: Procedures involved in the Use of L/C

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