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Trade and Foreign Policy Division
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Abstract

This study sought to examine the economic implication of EPAs on Kenya by analyzing trade relations between Kenya and EU, the implications of EPAs on regional trade and other trade arrangements, and the welfare effects on Kenya. Using trade statistics analysis and partial equilibrium approach, the study found that Kenya's exports to the EU market are dominated by a narrow range of primary commodity exports that include cut flowers, tea, coffee, vegetables and fish. The perceived preference margins that Kenya is to enjoy with the conclusion of EPAs are declining, and will continue to decline in the future since the EU is also negotiating FTAs with other countries/regions, and that multilateral trade liberalization under the WTO implies continued decline of tariffs and other trade barriers in the future. On trade arrangements, the study found that the conclusion of the WTO Doha Round will increase competition in the EU market and reduce policy space and flexibility that Kenya has negotiated under the EPAs. Although the simulation results show loss of tariff revenue as a result of trade liberalization, these are compensated for through net welfare gains as a result of reduced consumer prices and also increased trade creation.

On the policy front, the study recommends that for Kenya to benefit from EPAs, there is need to urgently address supply-side constraints such as inadequate infrastructure and low productive capacity of producers, which limit exportable surplus. Kenya should also enhance export growth and diversification from limited primary and natural resource-based commodities. In addition, Kenya must improve its competitiveness in order to retain and benefit from trade agreements such as EPAs because tariff and other trade barriers are decreasing over time in the international markets.

Abbreviations and Acronyms

AGOA	African Growth and Opportunity Act
CET	Common External Tariff
COMESA	Common Market for Eastern and Southern Africa
DFQF	Duty Free Quota Free
EAC	East African Community
EPAs	Economic Partnership Agreements
EU	European Union
FEPA	Framework for Economic Partnership
GATT	General Agreement on Tariff and Trade
GSP	Generalized System of Preferences
LDCs	Least Developed Countries
MFN	Most Favoured Nation
NTBs	Non-Tariff Barriers
PEM	Partial Equilibrium Method
RECs	Regional Economic Agreements
SADC	Southern African Development Community
SDP	Special and Different Treatment
SMART	Software for Market Analysis and Restrictions on Trade
SPS	Sanitary and Phytosanitary Standards
SSA	Sub-Saharan Africa
TBT	Technical Barriers to Trade
TFTA	Tripartite Free Trade Area
TIFA	Trade and Investment Framework Agreement
TRIPs	Trade Related Intellectual Property Rights
UNCTAD	United Nations Conference on Trade and Development
WITS	World Integrated Trade Solutions
WTO	World Trade Organization

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1. Introduction

1.1 Background Information

Trade relations between the European Union (EU) and Africa, Caribbean and Pacific (ACP) countries prior to year 2000 were guided by the Lome Conventions (1975-2000). Under the Lome Conventions, the ACP countries enjoyed non-reciprocal[1] market access on almost all exports to the EU, except for some agricultural products such as sugar and rice. The Lome Conventions, however, were not compatible with Article XXIV of the General Agreement on Tariffs and Trade (GATT), which requires all preferential trade agreements (PTAs) to be reciprocal, but can be asymmetrical in favour of developing countries. The Lome Conventions were also against the World Trade Organization (WTO) principle of the most-favoured-nation (MFN) treatment contained in Article 1 of the GATT[2], because it discriminated against other developing countries outside the ACP group and with similar economic circumstances.

In 2001, the EU sought a waiver from WTO members in order to guard against legal challenges of incompatibility. This would enable the EU to derogate from her international trade commitments, and to discriminate in favour of the ACP countries until 31st December 2007 when a comprehensive Economic Partnership Agreements (EPAs) compatible with WTO would have been concluded. The WTO Ministerial Meeting of 2001 granted the waiver to the EU and ACP and, as a result, the EU was allowed to provide non-reciprocal, duty free market access to ACP countries during the intervening period between 2002 and 2007, hence the Cotonou Agreement. For the waiver to be granted, the EU had to compensate her trading partners that felt that their trading rights were being curtailed by the ACP-EU trading arrangement (IEA, 2006).

The Cotonou Agreement came into force on 1st April 2003. The objectives are poverty reduction, promotion of sustainable development, and gradual integration of ACP countries into the world economy (Karingi and Deotti, 2009). The Agreement recognized that there were major differences in economic development between the EU and ACP countries. Most of the ACP countries are highly dependent on the EU market for exports due to past colonial relations, but the economic importance of ACP countries in terms of trade with the EU is very small. Majority of the EU countries are developed with high per capita incomes and export a wide variety of diversified and sophisticated goods and services.

[1] ACP countries did not have to provide equivalent trade benefits to the EU.

[2] Article I has a golden rule, "do unto others as you do to your best trading partner." This is the MFN clause, which states that countries cannot normally discriminate between their trading partners. Grant someone a special favour (such as a lower customs duty rate for one of their products) and you have to do the same for all other WTO members.

Under the Cotonou Partnership Agreement, the EU was to negotiate and conclude reciprocal new WTO-compatible trading arrangements with ACP, "progressively removing barriers to trade between them and enhancing cooperation in all areas relevant to trade".[3] These trade arrangements referred to as Economic Partnership Agreements (EPAs) were however not completed by 31st December 2007 according to the waiver granted. As a result, the EU proposed the initialling of interim framework of EPAs to provide a bridge until the conclusion of the negotiations. The interim EPAs contained a WTO compatible market access offer as well as a commitment to negotiate outstanding issues in EPAs. On 28th November 2007 in Kampala, Uganda, EAC partner states and the EU initialled an interim Framework for Economic Partnership Agreement - FEPA (South Centre, 2013). The FEPA comprised general provisions (scope, objectives and principles), trade in goods, fisheries, economic and development cooperation, provisions on areas for future negotiations, institutional and final provisions, and annexes and protocols.

The interim framework agreement was to be replaced by a comprehensive EPA with effect from 1st July 2009 by which time negotiations of all pending issues would have been concluded. By 2013, a number of areas had been completed (about 98%). The areas concluded by then included customs and trade facilitation, standards, sanitary and phyto-sanitary measures, and technical barriers to trade (TBT), fisheries, and economic and development co-operation. Some of the contentious issues that delayed the negotiations included:

(a) Market access issues

(i) The definition of other ACP countries: The EAC position was to retain the definition of "other African Caribbean and Pacific (ACP) States' as was in the FEPA to allow EAC partner states to source raw materials from ACP countries for processing and exporting to the EU on duty free basis. On the other hand, EU's position was that 'other ACP states' be defined as ACP states that will provisionally apply the EPA.

(ii) MFN clause: The EU position was that in the event the EAC countries conclude an FTA with major world economies with better terms than the EPA, EAC would be bound to extend similar terms to the EU.

(iii) Cumulation with South Africa: The EAC position was that they should be allowed to secure materials from South Africa to manufacture goods for export to the EU.

[3] http://ec.europa.eu/development/body/cotonou/agreement/agr18_en.htm.

(iv) Revision and application of rules of origin: The EU wanted EAC to extend flexible rules of origin on EAC list of sensitive products, despite the fact that these products are classified by the EAC as sensitive products to the EAC partner states. If the EAC/Kenya allowed flexible rules of origin on sensitive products, it would open the market to the EU's subsidized agricultural products, which would disadvantage EAC/Kenyan producers of products such as sugar, maize, milk and other dairy products.

(v) Duties and taxes on exports: The EU insisted that in the event the EAC partner states wish to impose export taxes on any exports, this should be done after consultation with the EU.

(b) Agriculture text (domestic support and export subsidies) and economic and development cooperation: The likely economic implication of domestic support and export subsidies is that it will reduce competitiveness of EAC goods in both domestic and EU markets.

(c) New issues introduced by the EU: Cooperation in the tax area and consequences from customs union agreement concluded with the EU and issues of human rights and governance.

Although the negotiations for EPAs did not meet the set deadline of 30th September 2014, they were finally completed and signed in Brussels Belgium on 14th October 2014. Most contentious issues were ruled in favour of EAC. This means that Kenyan/EAC exports to the EU will continue to access the market duty free quota free (DFQF) except for HS 93 - arms and ammunition (on which MFN rates apply). The comprehensive EPA that was signed has in-built flexibilities including: asymmetric agreement in favour of the EAC in terms of the level of trade liberalization; excluded products (sensitive products); trade remedies provisions such as safeguard and countervailing measures; amendment clause when there is need to notify intentions to make amends to any section (including tariffs); a review clause (the agreement can be reviewed after 5 years) and an exit clause where a partner will require to issue a notice of one year to the other parties (Rotich, 2014).

With the signing of the EPAs, the next step includes: legal scrubbing, translation of the agreement into 24 EU languages and Kiswahili, signing by the relevant Ministers, ratification by all the EU and EAC countries in accordance with their internal Constitution and other laws, entry of the EPA into force, and finally implementation of the agreement. This will also include sensitization of relevant stakeholders.

1.2 The Comprehensive EU-EAC EPA Agreement

The comprehensive agreement concluded and signed by senior officials from both parties on 14th October 2014 covered the following areas: a) Trade in goods, b) SPS/TBT measures, c) Customs and trade facilitation, d) Trade defense measures, e) Fisheries, f) Agriculture, g) Economic and development cooperation, h) Institutional arrangement, final provisions, and dispute settlement, and i) Good governance in the tax area.

For trade in goods, the EAC is the only African region in which all signatories have identical schedules. These are all based on reductions from the EAC common external tariff (CET) and none requires a country to start removing any positive tariffs. In the agreement, the EU liberalized 100 per cent of its market. On the other hand, the EAC offered to liberalize as follows:

(i) 82.6 per cent within a transition period of 25 years. Liberalization is planned to take place in three phases. The first phase is planned to take five years and involves only products with a CET of zero per cent; that is, products covered in this phase do not attract any import taxes under the EAC Customs Union CET (these are raw materials or capital goods). This constitutes 65.4 per cent of EAC's imports from the EU, meaning that in the first phase there is no change in EAC as EAC CET is already in place. The second phase will take 8 years within which the EAC partner states will liberalize a further 14.6 per cent. Products in this category are intermediate inputs and attract 10 per cent duty. The third phase will take 13 years within which the EAC partner states will liberalize a further 2.6 per cent of their imports from the EU. In this phase, there are finished products, whose availability at lower cost is deemed to have a positive effect on consumer welfare, and not to have a potentially negative impact on EAC economies.

(ii) 17.4 per cent excluded from liberalization (mainly agricultural, dairy, textiles products and other products of strategic importance to the economy). These products were identified based on contributions to rural development, employment, livelihood sustainability, promotion of food security, fostering infant industries, and contribution to government revenues. Products deemed to contribute or to have a potential to contribute to increased production and trade competitiveness were excluded from the list. All products subsidized by the EU are on this list (Rotich, 2014).

A summary of EAC's market access offer is provided in Table 1.1 (see also Table A1 in Appendix).

Even after concluding the EPAs, negotiations on some pending areas under the Rendez-vous clause will continue. The areas for future negotiations include:

Table 1.1: Summary of EAC market access schedule

Category of products/ tariff lines subject to liberalization	Number of tariff lines	EAC CET (%)	Tariff phase down period and rate	% of trade (value)	Rationale used in the negotiations
Exclusion list	1,323		Will Not be Opened up to the EU imports		Protection of agriculture, food security and rural development, industry and regional integration
Raw material/ capital goods/ Essential goods such as medicaments	1,920	0	2010 – Tariff already at zero so no further reduction	65.4	Already zero rated under EAC customs union
Intermediate goods	1,040	10	10 years tariff phase down at the rate of 10% p.a	14.6	Industrial inputs which EAC industries import from EU, but are not produced in the EAC
Finished products	865	25	25 years tariff phase down at the rate of 10% p.a	2.6	Largely non strategic products in the context of Kenya (and EAC) industry and agricultural sector development.
Total trade coverage of EAC trade liberalization				82.6	

Source: Rotich, 2014

- Trade in services;
- Trade related issues, namely competition policy; investment and private sector development; trade, environment and sustainable development; intellectual property rights; transparency in public procurement, and;
- Any other areas that the Parties may agree upon.

1.3 Kenya's Trade with the EU

Kenyan exports to the EU have been declining over time from 29 per cent of total Kenyan exports in 2009 to 25 per cent in 2013 (KNBS, 2014). The leading exports include vegetables and other products (48%), coffee (18%) and tea (17%) (see Table A3 in Appendix). This is despite the free access to the EU market for Kenya products under the Cotonou Agreement and FEPA.

On the other hand, Kenyan imports from the EU have averaged around 20% of the total Kenyan imports in the last five years. Among the main imports are motor vehicles (6%), medicaments (4%), and paper and paperboard (4%) - Table A4 in Appendix.

Overall, Kenya's trade with EU has been expanding since 2000, but in favour of the EU. Kenya has continued to export primary commodity exports to the EU, while importing high technology commodity imports, hence the widening of the trade balance between them.

1.4 Statement of the Problem

The negotiations on EPAs were concluded and signed in Brussels, Belgium on 14th October 2014. The Kenyan/EAC exports will access the EU market duty free quota free (DFQF) except for HS 93 - arms and ammunition. On the other hand, under EPAs, Kenya/EAC will liberalize 82.6 per cent of their market for the EU products in the next 25 years. Only 17.4 per cent of the EU exports to EAC will be excluded from liberalization (see EAC exclusion list of sensitive products in Table A1 in the Appendix).

There are several advantages that are likely to accrue to the country with the signing of EPAs. These include: firstly, increased predictability and credibility of the Kenyan economy. Secondly, the most efficient firms might improve their integration into the global supply chains. Thirdly, the potential market and economic disruptions resulting from the country accessing the EU market under non-preferential terms will be avoided. In this case economic agents will be able to make long-term investment and production decisions. Lastly, the EPA is likely to benefit consumers through cheaper imports from the EU in cases where there are few or no competing domestic producers. In addition, potential welfare gains could also result from sourcing imports from more efficient EU producers.

Despite the above advantages, Kenya and other ACP countries are concerned with the possible negative effects of EPAs as identified by Fontagne et al. (2003). First, there are fears that producers in Kenya and ACP countries will be hurt by increased competition from EU producers. Second, there is a likelihood of significant revenue loss due to tariff cuts, with adverse effects on national budgets. Third, there are potential welfare losses or adjustment costs, in the case where domestic production is undermined by cheap EU imports, or where more efficient producers from the rest of the world are displaced.

Whereas trade preferences can play a useful role in enhancing exports and economic growth, the dynamic effects on Kenyan economy is not quite clear. For the EPAs to be of strategic interest to Kenya, the benefits must outweigh the costs and this can only be verified empirically.

1.5 Objectives of the Study

The overall objective is to assess the implications of EPAs on Kenya. The specific objectives are to:

(i) Review trade relations between Kenya and EU;

(ii) Analyze the implications of EPAs on regional trade arrangements and other trade negotiations;

(iii) Examine the trade, revenue and welfare effect of EPAs on Kenya; and

(iv) Propose policy recommendations.

1.6 Significance of the Study

The EPAs will have major implications on Kenya in terms of trade creation,[4] trade diversion[5] and overall welfare effect. EPAs open the EAC market to the EU products in 25 years. Considering that Kenya exports mainly manufactured products such as chemical, machinery, food products, beverages and tobacco, cement, vegetable oils and fats to both the EAC and Common Market for Eastern and Southern Africa (COMESA) region, the opening up of the region to the EU products will affect Kenya's trade position in the region.

[4]Trade creation means that a free trade area creates trade that would not have existed. As a result, supply occurs from a more efficient producer of the product with the FTA.

[5] Trade diversion means that a free trade area (FTA) diverts trade, away from a more efficient supplier (producer) outside the FTA, towards a less efficient supplier within the FTA.

2. Literature Review

2.1 Theories of Regional Integration

The theories of regional integration draw their rationale from the Standard Trade Theory, which sees free trade as the best policy in enhancing gains from trade. A country should specialize in producing and exporting the commodity with which it has a comparative advantage and import that in which it has comparative disadvantage. From this basic principle, it is assumed that free trade among two or more countries would improve welfare of the member countries as long as the arrangement leads to net trade creation. That is, the arrangement leads to trade creation, minimal trade diversion and/or trade creation that exceeds trade diversion (Ng'eno et al*.,* 2003).

The formal economic integration takes place in stages, beginning with the lowering and removal of trade barriers to the formation of economic and political blocks as described below.

- Free Trade Area (FTA), where a group of countries remove all tariffs and other barriers to the free flow of goods and services between each other, but each country keeps its own tariffs in regard to non-member countries.
- Customs Union (CU), an FTA with common trade policies towards non-member countries; that is, member countries have the same or common tariffs on imports from non-members (CET).
- Common Market, a custom union where in addition to the free movement of goods and services, countries establish free movement of factors of production, such as labour and capital , which are free to move within the member countries.
- Economic Community (Union): In addition to the common market, the member countries harmonize a number of key policy areas, including monetary and fiscal policies, as well as labour market, regional development, transportation and industrial policies, among others. A further step in the economic union is the establishment of monetary union with a common currency in use among the member countries.
- Political Union: An economic community where countries chose to give up political sovereignty to become a federation or political union with common legislation and political structures. This represents the most advanced form of integration, whereby the economic and political systems of the member countries are coordinated.

It is, however, important to note that in practice, some agreements may not necessarily follow the above stages strictly. For example, in the case of the EAC, the entry point was the Custom Union in 2005.

Most theories take integration as a process for reducing international tensions and improving the lot of humanity (Harrison, 1974). Some of the main theories of integration identified in the literature include; the functionalism, neo-functionalism, inter-governmentalism, organizational theory and supranational governance theory.

The functionalist thesis upon which most of the popular theories of integration are based is attributed to Mitrany (1966), who states that authority should be linked to a specific activity so that the traditional link between authority and a definite territory can be broken. The functionalists hold that a universal human welfare can be achieved if states share a common interests and needs through a process of global integration triggered by the erosion of state sovereignty. That states sovereignty should be transferred to a new authority, which will increasingly use scientists and experts in the process of policy-making. Put differently, how do we weld together the common interests of all without interfering unduly with the particular ways of each individual? The solution, according to Mitrany (1966), is to promote technical rather than political institutions.

Neo-functionalist theory is centred on the view that society is composed of various groups of interests, and the integration process would better satisfy them. Essential for the neo-functionalist thesis is the idea of spillover, according to which integration would deepen from economic to political, and the result an integrated union of states that would acquire the characteristics of 'domestic political systems' (Rosamond, 2001). Another key element is the existence of a high authority (above the nation states), which would give the integration process the right direction.

Inter-govenmentalism considers economic inter-dependence as a necessary condition for integration (Moravcsik, 1993). Moravcsik argues that integration goes as far as member states want it to go, and regional institutions exist due to the deliberate will of member states to satisfy their interests and are instruments for achieving member states' objectives.

Supra-national governance theory (Sandholtz and Alec, 1998), on the other hand, draws heavily from neo-functionalism. It highlights the "inherent expansionary" nature of integration processes, sustained "by means of policy feedback" and the role of supra-national organizations. Integration favours devolution of power from the state to both sub- and supra-national levels, but with significant differences among sectors of policy-making. However, it does not dismiss the power of national governments and the primacy of inter-governmental bargaining in a number of areas.

2.2 Economics of Preferential Trade Agreement

EPAs are trade arrangements meant to create an FTA between EU and ACP group of states. EPAs have replaced the non-reciprocal and discriminating preferential trade agreements offered by the EU under the Cotonou Agreement, which were incompatible with WTO rules.

There is a domino effect that encourages countries to form regional economic blocs. According to Baldwin (1993), this arises from the fear of exclusion from the expected gains of trade arrangement; countries that are not members will have their profits and market share damaged. Countries have been motivated to form PTAs due to frustrations arising from slow pace of trade negotiations at the WTO, and there is still no indication of when or whether they will be concluded. It has been argued that the PTAs can complement multilateral trade liberalization. Most of the countries, especially in Africa, enter into regional economic communities (RECs) to overcome limitations associated with small markets, and increase their voice and negotiations in the international fora.

Panagariya (2000) argues that preferential trade agreements (PTAs) can be referred to as union of two or more countries, among which lower or zero tariffs are imposed on each other relative to what is imposed to non-members. The countries in question may not necessarily share a boundary as is the case between trade relations between the ACP and EU countries under EPAs (WTO, 2011).

The theoretical underpinning of PTA traces its origin from Viner (1950) in his early work on the formation of a customs union. The static welfare analysis focused on the changes in production structure after the formation of a FTA, in order to determine trade creation or trade diversion. Trade creation is welfare enhancing, while trade diversion reduces national welfare. The overall effect on welfare depends on the relative sizes of the two. When trade creation predominates trade diversion, there is an overall welfare gain and vice versa.

Lipsey (1957) makes an argument that negative effects of trade diversion on welfare emanates from implicit exclusion of consumption effect. According to this argument, gains from reduced prices of imports could possibly offset losses arising from shifting production from a low cost producer outside the FTA to a higher cost producer within the FTA. Thus, a member country can gain welfare from an FTA even in the presence of trade diversion. Bhagwati (1971) further argues that absence of substitution in consumption may not necessarily be welfare decreasing. According to him, welfare decreasing effects of trade diversion happen with restriction on imports rather than consumption pattern.

Welfare effects resulting from FTA formation are not solely determined by trade creation or trade diversion. The degree of cost saving from trade created and added costs as a result of trade diversion also matter. In addition, tariff revenue loss as a result of reduction or elimination of tariffs might outweigh net gains from trade creation and consumption effect, especially where tariff elimination does not translate into lower domestic prices. The higher the tariff preference, the larger would be the welfare loss from an FTA (Adamu, 2013). There are instances when the formation of an FTA may make member states to increase protectionist tendencies against non-members. As a consequence, endogenous protection converts any trade creation within the FTA into trade diversion (Bhagwati and Panagariya, 1996).

2.3 Empirical Literature on Impact of EPAs

Studies on revenue implication of EPAs include Karingi *et al.* (2005); Milner *et al.* (2005); Zouhon-Bi and Nielson (2007); Mkenda and Hangi (2009), among others. The study by Karingi *et al.* (2005) using partial equilibrium models[6] finds that revenue loss was low for countries in Southern African Customs Union (SACU), but significant for the other countries. In this study, Kenya was to lose the highest amount of revenue estimated at US$ 107,281,328 compared to US$ 9,438,170, US$ 7,664,911 and US$ 5,622,946 for Uganda, Burundi and Rwanda, respectively. Mkenda and Hangi (2009) used partial equilibrium (PE) to study revenue implications of EPAs on Tanzania. The study found that revenue loss from tariff reductions is very significant given that customs revenue for Tanzania constituted about 44.2 per cent of total revenue. Zouhon-Bi and Nielson's (2007) study revealed that the impact of fiscal revenue for Economic Community of West African States (ECOWAS) countries would be significant. The study observed that revenue shortfalls could be mitigated because of the possibility of product exclusions, the length of period of EPA implementation, domestic tax reforms, and revenue gains as a result of trade-led induced growth. According to Milner et al. (2005) in a study that applied PE model, the welfare effect, whether positive or negative for the EAC countries was small.[7] However, the ACP countries would experience adjustment costs especially in terms of revenue losses.

[6] The studies used the world integrated trade solutions (WITS) model and the software for market analysis and restriction on trade (SMART) models.

[7] The EAC countries at the time of the study were Kenya, Uganda and Tanzania.

A study by Kenyan Association of Manufacturers (KAM, 2013) indicated that if the EPAs are not signed, Ksh 8.7 billion worth of investments would be lost, 20,816 direct job losses and 40,000 persons indirectly engaged by firms exporting to the EU will lose their jobs.

Other EPAs studies have been region-specific. For example, Milner et al. (2002) considered the case of EPAs between the EU and ACP countries and made a conclusion that trade diversion in the EAC region would compromise integration efforts and trigger de-industrialization. The results of the study further indicated that Kenya would lose significant market share in Uganda and Tanzania. Sindingre (2008) analyzed the impacts of EPAs on Sub-Saharan Africa (SSA) and showed that outcomes depended on countries and initial conditions, structures of their economies and regional context. Other important factors included global conditions, domestic market structure, EU trade policies, and international prices among others. The study observed that EPAs would enhance SSA exports and competitiveness, and that EPAs would be more efficient than multilateralism. Potential risks include trade diversion, heightening of overlapping membership problem, loss of revenue, and erosion of industrial bases.

Morrissey and Zgovu (2009) used the PE model to examine the effect of complete elimination of import tariffs on agricultural products from the EU and excluding 20 per cent of imports as sensitive products. The results show that more than half of the ACP countries were likely to realize welfare gains. However, the overall effect on gross domestic product (GDP) growth, positive or negative, was very small with most gains being less than 0.1 per cent of GDP. Potential losses of tariff revenue were negligible, but observed that there was scope for tax substitution given that countries had a 10 year period to implement tariff reductions. The study concluded that there is no need for ACP countries to be overly concerned about the impact of EPAs.

Berisha-Krasniqi *et al.* (2008) using Modeling International Relationships in Applied General Equilibrium (MIRAGE) CGE model examined the potential impact of EPAs on ACP countries with a particular focus on Senegal. The study revealed that Senegal would not benefit significantly from EPAs since it already had good market access through the Cotonou Agreement preferential scheme and Everything But Arms (EBA) initiative. For countries in SADC, Eastern and Southern Africa (ESA), the Caribbean and Pacific, EPAs was trade creating, but trade diverting for Nigeria, Senegal and Western, Eastern, and Central Africa (WECA). Under EPAs, Senegal would lose 46 per cent in its public revenue, Nigeria 31 per cent and the rest of ECOWAS 37 per cent. This confirms ACP countries' concern that EPAs would compromise their fiscal stability. According to this study, some countries would experience significant price decrease in world prices of agricultural commodities such as raw milk and dairy products, wheat, paddy and processed rice, among others.

Keck and Piermartini (2005) used the GTAP model to simulate the impact of EPAs on SADC countries. The results indicated an overall welfare enhancement on SADC countries and substantive increase in real GDP. Perez and Karingi (2007), also applying a GTAP model, revealed that EPAs would create asymmetrical gains between African and EU producers. Possible gains by African producers were limited because majority of them were already enjoying preferential treatment and experienced supply-side constraints. The EU countries could increase their market share in ACP countries even in the presence of tariff barriers. Trade balance was in favour of the EU and a possibility of local and regional production substitution by EU imports. The study concluded that asymmetry in terms of commitment between EU and African countries should be allowed, and that 80 per cent reciprocation by the EU would not be enough to preserve Africa's trade, fiscal and industrial balance.

A comprehensive study undertaken by the Kenya Institute for Public Policy Research and Analysis–KIPPRA (2005) to examine the potential effects of EPAs on the Kenyan economy found that net welfare gains in Kenya ranged between +0.7 per cent and -0.1 per cent of Gross Domestic Product (GDP). However, after including sensitive products, EPAs were welfare enhancing, but trade creation was in favour of the EU with a possibility of 14 per cent substitution from EAC countries to the EU. Products that were likely to face competition from the EU included fertilizer, cement, salt, medicaments, paper and paper products, footwear, insecticides, maize, wheat, milk and milk products. Horticultural products, coffee and tea exports were likely to remain the same or increase substantially, especially if EU subsidies on horticultural products are withdrawn or there is a reduction of tariffs on products such as tea and coffee. The study concluded that depending on the elasticities of supply and demand, costs of EPAs would outweigh their benefits, unless there is a transition period during which the EU does not enjoy reciprocal preferences.

Perez (2006) used general equilibrium analysis and disaggregated tariff calculations and estimated the effects of EPAs on the ACP countries. The results indicated that it would be less costly for most ACP countries to switch from Cotonou preferences to the GSP and EBA initiative than adopting EPAs. The study further revealed that a GSP+ option would make an optimal choice for the ACP countries.

2.4 Overview of Literature

Many impact models and impact studies have been undertaken on the effects of EPAs on ACP countries and they show mixed results. An overwhelming majority of these studies show that EPAs will lead to revenue loss, consequently cause fiscal disturbance (Karingi *et al.*, 2005; Zouhon-Bi and Nielson, 2007; Morissey and Zgovu, 2009). This confirms the ACP countries' fears that they would experience significant revenue reduction unless there are appropriate compensatory mechanisms designed. Some of the studies find that the EU will benefit more than the ACP countries (Perez and Karingi, 2007). However, the previous studies, particularly for the EAC region, do not consider the actual tariff liberalization phases stipulated in the EU-EAC EPAs for which this study seeks to establish.

3. Methodology

This study used statistical and a partial equilibrium analysis in order to achieve the stated objectives.

3.1 Partial Equilibrium Approach

The partial equilibrium framework was preferred in this study due to several factors. First, it has simple data requirements for carrying analysis. For instance, in this analysis, only import data for a particular year disaggregated by source, that is EAC, EU and ROW and product classifications were considered. Second, the results are relatively easy to interpret, hence are user friendly to policy makers and trade negotiators. Third, a partial equilibrium, unlike general equilibrium models, allows for analysis to be conducted at very high levels of disaggregation. This is useful in developing alternative scenarios and identifying sensitive products at the highest level of aggregations. In this case, we used data based on HS 8 digit aggregation levels.

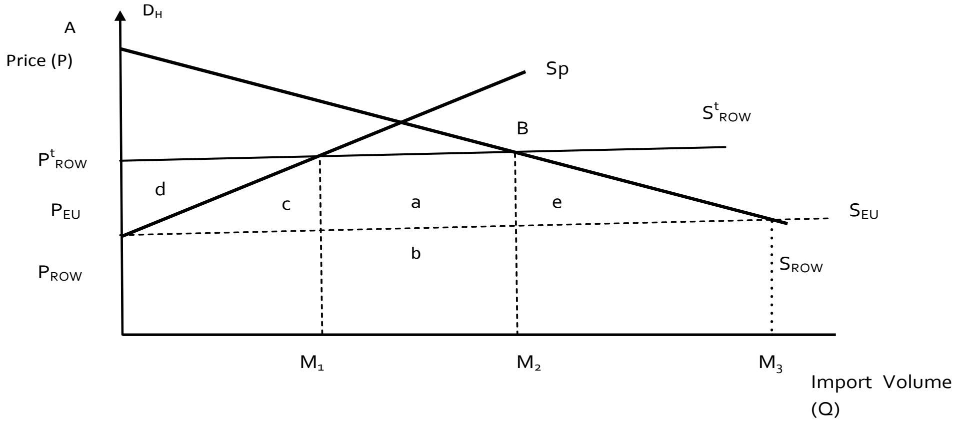
The model has weaknesses, despite the above positive attributes. The model is static and does not follow responses to price changes by other economic agents, including producers, firms and consumers as is the case with general equilibrium models. In addition, the analysis does not take into account the changes in the economies of trading partners and possible changes in demand for exports.

3.2 Analytical Framework

A graphical presentation illustrating how changes in tax rates affect cross-border trade, government revenues and household welfare through the price system within a regional integration framework is presented in Figure 3.1, following Panagariya (1998) and Milner et al. (2010). Assuming perfectly competitive markets, and perfect substitutability between imports from different sources and domestically produced import substitutes, we consider two countries: a small home economy (H) and partner country (P) with an upward sloping supply curve. The two initial supply curves of the EU and the rest of the world (ROW) are assumed to be infinitely elastic.

Assume that *P* and *H* form a PTA and *H* is a small economy relative to the *P* and the *ROW* whose supply is constant cost (prices P_{EU} and P_{ROW}, respectively). From Figure 3.1, it is assumed that $P_{EU} > P_{ROW}$. As such, discriminatory policies within the PTA can have trade creation and trade diversion effects. The line *DH* is *H*'s demand for imports, S_p is partner's supply of exports, and S_{EU} and S_{ROW} are export supply functions for the EU and the ROW, respectively.

Figure 3.1: The effects of an EAC-EU EPA



Source: Milner et al. (2008)

Within the PTA, there is a non-discriminatory *ad valorem* tariff (*t*) on imports outside the PTA (where $P^t_{ROW} = P_{ROW}(1+t)$, but P^t_{EU} is not). *H* imports OM_2 in total with OM_1 coming from *P* and M_1M_2 from the ROW. Further, assuming that there is no domestic production, welfare (*W*) can be defined by referring to consumer surplus, with respect to import demand function (D_H). Thus, *W* for the home country is given by triangle $ABP^{(t\_ROW)}$, and the tariff revenue of imports from countries outside the PTA is represented by the area *(a+b)*.

Under the EPA, t applies to ROW but not to the EU (imports from the EU enter H duty free within the EPA framework). The supply prices now become PEU, with the total quantity of imports rising from OM_2 to OM_3 (with all imports post-EPA coming from EU). There are three components of this trade-effect of the EPA; a consumption expansion effect (M_2M_3); a trade diversion effect M_1M_2); and trade creation effect OM_1.

Trade diversion occurs when trade is diverted from more efficient extra-PTA suppliers to less efficient suppliers within the PTA. The EPA diverts trade between extra-PTA suppliers; M_1M_2 is imported from less efficient EU rather than from the ROW. The cost of this trade diversion is represented by area *b*, with total tariff revenue lost by the home country being area (*a*+*b*). Trade creation occurs when inefficient domestic production is displaced by globally efficient extra-PTA suppliers. In the case of EPA, less efficient intra-EAC imports are displaced by more efficient imports from the EU.

The overall resource-saving of trade creation is represented by area *c* in Figure 3.1. This and the loss in producer surplus for partner country exporters (area *d*) allow consumer surplus on this component of the trade effect of the EPA to increase by area (*c*+*d*). In the end, the welfare implications for the *H* country of shifting from the PTA to the EPA is ambiguous; consumption and trade creation effects increase welfare while trade diversion decreases welfare; that is, $\Delta W=(c+d+e) - b$. Thus, the more efficient the EU is, the smaller trade diversion will be and the possibility for the EPAs to be welfare improving.

3.3 Specification of the Model

The study borrows from the PEM approach developed by Panagariya (1998) and Milner *et al.* (2008). The framework distinguishes between those sectors where ROW is the dominant supplier and EU is the dominant supplier prior to formation of EPA. The model distinguishes three blocks of countries: that is the European Union (EU), the EAC group and the rest of the world (ROW). In this regard, three components of trade effects are simulated: consumption/revenue effects, trade diversion effects, and trade creation effects.

Case 1: Consumption effects only

In the sectors where the EU is globally efficient and the dominant supplier to the EAC market before the formation of EPAs, it can be assumed that only consumption effects would follow from EPAs. Thus, for the sectors where the EU is the dominant supplier, consumption effect alone (ΔM^c) can be estimated relative to the existing EU import levels as follows:

$$\Delta M^C = \left[\frac{t}{1+t}\right].e_M^D.M_0^{EU}.UV_0^{EU} \qquad \text{.......(1)}$$

where t is the current tariff against imports from the EU, e_M^D is the price elasticity of demand of imports, M_0^{EU} is the current volume of imports from the EU, and UV_0^{EU} is the current average unit value of imports from the EU. The revenue (ΔR^C) and welfare (ΔW^C) effects associated with this are, correspondingly:

$$\Delta R^C = -t.UV_0^{EU} M_0^{EU} \qquad \text{.......(2)}$$

$$\Delta W^C = 0.5t.\Delta M^C \qquad \text{.......(3)}$$

Case 2: Trade diversion with consumption effects

For those sectors in the EAC where the ROW is the dominant supplier, further assumptions regarding the competitiveness of EU supply to the EAC is required. If $P_{EU}<P^t_{ROW}$, given constant cost technology over the relevant range, the EPAs will divert all the imports for ROW to the EU. Thus, the upper limit of the value of trade diversion (ΔM^{TD}) is:

$$\Delta M^{TD} = M_0^{ROW} .UV_0^{ROW} \quad \text{......}(4)$$

where M_0^{ROW} is the current quantity of imports from ROW and UV_0^{ROW} is the current average unit of imports from ROW. The tariff revenue effect (ΔR^{TD}) due to this trade diversion is given by:

$$\Delta R^{TD} = -tUV_0^{ROW} M_0^{ROW} \quad \text{......}(5)$$

For these sectors, there will also be consumption effects ΔM_{TD}^{C}

Given that one may not have information about where the price of EU imports may lie between P_{ROW} and P^t_{ROW}, one can take an average of the two and assume that is where PEU lies as follows:

$$\Delta M_{TD}^{C} = 0.5\left[\frac{t}{1+t}\right].e_M^D.M_0^{ROW}.UV^{EU} \quad \text{......}(6)$$

Given the assumption about *PEU*, the overall welfare (W^{TD}) can be approximated (impact of trade diversion with consumption effects) as follows:

$$W^{TD} = 0.25t\Delta M_{TD}^{C} - 0.5tUV_0^{ROW} M_0^{ROW} \quad \text{......}(7)$$

Case 3: Trade creation with consumption effects

Assuming that the EU is more efficient supplier that the ROW, if the duty free supply price from the EAC partner lies over the relevant range between P^t_{ROW} and P_{EU}, then all of the current imports from the region to the home country will be replaced by more efficient production from the EU. Therefore, the maximum value of trade created (ΔM^{TC}) for the EU by this deflection from EAC region sources can be estimated by:

$$\Delta M^{TC} = M_0^{EAC} .UV^{EAC} \quad \text{......}(8)$$

where M_0^{EAC} refers to the current quantity of imports from EAC partner and UV^{EAC} is the current average unit value of imports from EAC partner.

In order to estimate consumption effects in these sectors (M_{TC}^{C}), assume that the price from the EAC partner is as high as the tariff-inclusive price from the EU. In this case, the pre-EPA tariff rate against the EU imports provides an (upper) estimate of the extent to which the import price can fall as a result of EPAs. Thus:

$$M_{TC}^{C} = 0.5\left[\frac{t}{1+t}\right].e_M^D.M_0^{EAC}.UV^{EU} \quad \text{......}(9)$$

The combined welfare (ΔW^{TC}) effects of trade creation with consumption effects can be identified by:

$$\Delta W^{TC} = 0.5t.M_{TC}^{C} + (UV^{ACP} M_0^{ACP})t \quad \text{..(10)}$$

Estimating the model, the following key assumptions were made:

(a) The PEM is a static model.

(b) There is perfect substitutability between domestic and imported products. The Armington elasticities (substitutability between domestic and imported products) were assumed to be 1.15 before EPAs, 1.50 during the 1st phase of liberalization, 2.00 during the 2nd phase of liberalization, and 2.15 during the 3rd phase of liberalization. These elasticities lie within the general assumption that import demand elasticities for developing and poor countries lie between 1 and 3 (Taylor and Taylor, 2004). In addition, the increase in the elasticities is meant to reflect the likely increase in domestic demand for imports from the EU as tariffs are lowered.

(c) It is assumed that the 2013 data is representative of the likely trade patterns in future between Kenya and the rest of the world.

The simulations are carried out in three scenarios:

The first scenario is basically liberalization during the first year into the EPAs. During this phase, the tariffs for products under Annex IIB of the consolidated EPA text are reduced by 20 per cent; that is from 10 per cent to 8 per cent, while those under Annex IIC are reduced by 5 per cent; that is from 25 per cent to 23.8 per cent.

In the second scenario which will take place after eight (8) years into the EPAs, tariffs for products under Annex IIB are reduced by 100% to zero, while those under Annex IIC are reduced by 20 per cent.

The final scenario is where the products under annex IIC of the schedule are reduced to zero and upon which liberalization will cover 82.6 per cent of the tariff lines.

This PEM analysis has the following advantages:

- It has minimal data requirements unlike the general equilibrium models.
- The data required is not inbuilt, and it thus allows the use of Kenyan trade dataset.
- It allows for analysis at a disaggregated level and therefore overcomes

aggregation bias associated with general equilibrium models. Commodity details, especially the sensitive products, are of particular interest to ACP countries (Milner et al., 2008).

Thus, PEM analysis presents more accurate results because the EPAs negotiations occur at a much disaggregated level. Moreover, the PEM results are transparent and easy to implement owing to their simplicity.

3.4 Data

The study used import data for Kenya during 2013. The data was disaggregated at HS 8 digit levels and at source levels: the EAC, EU and Rest of the World. In addition, we used data on import duties as well as domestic taxes, including VAT and excise duties, to carry out various simulations. The trade data used in this study has been obtained from Kenya Revenue Authority (KRA), International Trade Centre (ITC), and Export Promotion Council (EPC).

4. Findings

4.1 Implications of EU Trade Agreements with other Countries/ Regions to Kenya

Since 1963, the EU has signed and is negotiating bilateral trade agreements with many countries and regions of the world, whose effect is the reduction of tariff and other barriers to trade (for example, quotas and less restrictive rules of origin) on selected goods. Currently, there are 12 trade negotiations under EU; 9 are complete but are yet to enter into force, and thus the EU has trade agreements with some 50 partners. As the EU continues to offer trade preferences to these countries/regions, the preferential margin will continue to shrink. Some of these countries will pose competition for some of Kenyan products in the EU. For instance, Colombia is a major exporter of cut flowers, the leading commodity export by Kenya to the EU. Other countries such as China, South Korea, India, Indonesia, Thailand and Mexico are low-cost exporters of textiles.

4.2 Implications of EPAs on Other Trade Arrangements

4.2.1 Tripartite Free Trade Area (TFTA) negotiations

The three regional economic communities–RECs (EAC, COMESA and SADC) launched the negotiation for the establishment of TFTA in June 2011 in South Africa. The negotiations are ongoing, although initially they were scheduled to be completed by the end of 2014. The TFTA negotiations comprise of 26 countries, 22 of which are already participating in their respective FTAs, therefore forming a critical mass necessary to establish Tripartite FTA.

The three RECs are, however, negotiating EPAs with the EU separately, and in different configurations: the SADC-EPA, the EAC-EPA, and the Eastern Southern African (ESA)-EPA. Already the EAC, SADC and some individual countries within the framework of ESA have initialed different interim agreements with the EU under EPAs on trade in goods (see Table A2 in the Appendix).

The negotiations for EPAs agreement with the EU may have a negative impact on Africa's regional integration process because regional markets will be opened up to the EU before they are consolidated internally. It is important for the African regional groupings to be sufficiently integrated among themselves before they sign the final EPAs FTA, otherwise the conclusion of an EPA could potentially undermine harmonization in terms of the CET, customs clearance procedures and documentations, among others, in the three RECs.

The launch of the TFTA was out of the recognition of the growing importance of intra-African regional trade and, therefore, the need to, among other things, remove trade barriers and harmonize trade policies within the three regional blocks. However, the three regional blocs have signed with the EU different interim agreements with different content, schedules of implementation and exclusion list (sensitive list of products). This in a way creates three trade regimes within the TFTA, hence fragmenting rather than integrating the RECs, with the consequences of hampering deeper regional integration. Over and above this scenario, South Africa already has an FTA-TDCA with the EU, which puts another layer of complexity in harmonizing the three RECs.

In the TFTA regions, only the EAC has a harmonized list of products to be excluded from liberalization. Among the three trade blocs forming the TFTA, EAC is the most advanced and already has a customs unions and is implementing the common market protocol; this is not the case with COMESA and SADC. Within COMESA, there are countries (for example, Djibouti, Ethiopia, Eritrea and Sudan) that might not have incentives to join EPAs because they can gain DFQF market access under everything but arms (EBAs) (EU, 2014). Thus, there is a likelihood of increasing heterogeneity in the trading blocs and in effect complicating their harmonization.

At some point in the future, TFTA member states might encounter a situation where they will be negotiating a TFTA EPAs with the EU, where these complications will play out and thus derailing trade negotiations. However, there is another view that trade negotiations are undertaken by one team. The team that negotiates for Kenya in the EAC, COMESA, and EPAs is the same team that is negotiating the TFTA. Therefore, it can be anticipated that some of the complications that might be encountered in the EPAs and related to the regional trade arrangements are taken into account.

AGOA is a non-reciprocal trade preference programme that provides duty-free treatment to U.S. imports of certain products from eligible Sub-Saharan Africa (SSA) countries. The Act was first signed into law in May 2000 by President Clinton (AGOA I). President Bush further extended the Act in August 2002 (AGOA II). The current AGOA III (AGOA Acceleration Act 2004) was signed in July 2004 by President Bush and expires on 30th September 2015. There are 49 candidate SSA countries, with 39 currently eligible for the preference benefit. In terms of tariff benefits and general eligibility criteria, AGOA is similar to the existing GSP, a non-reciprocal concession under which developed countries allow duty-free or low-duty entry of imports from more than 120 developing countries up to a certain limit or quota, covering 4,600 products. AGOA built on the GSP idea but expanded product coverage by an additional 1,800 product lines to a total of 6,400 products, and included many critical developing world exports, in particular textiles and apparel. Local content restrictions were also subsequently eased for particular products. Additionally, AGOA includes trade and development provisions beyond its duty-free preferences.

The AGOA initiative has led to a rapid growth of SSA exports to the United States. With the AGOA initiative, exports by Kenya to the United States have improved over the years, largely due to apparel exports, to stand at US$ 293 millions 2012. The AGOA initiative, however, comes to a close in 2015. The US Administration and congress have indicated their wish to see the continuity of AGOA beyond 2015 on a permanent basis, with reciprocity after some time (Lande *et al.*, 2013). The US administration, however, feels that extension of AGOA beyond 2015 should take note of the changed environment in the world, including Africa. The US seems to be inclined more towards moving away from unilateral trade preference programmes.

Now that EPAs have been concluded, the US may also want to have a similar arrangements in the context of AGOA. This is because of the impact that EPAs will have on the US exports in Africa. It has been observed that the US exports in Africa will be displaced by the EU exports (Lande *et al.*, 2013) and therefore the need for an EPA-like arrangement to address the impact of EPA on the US exports to Africa. Second, since EPAs are expected to be WTO compatible, the US might be under pressure to have an AGOA arrangement that is also WTO compatible. In this connection, therefore, it will be a big challenge for the US to be granted a WTO waiver to extend AGOA in its current form.

4.2.2 WTO trade negotiations

One of the key principles of the WTO multilateral trade system is the Most-Favoured-Nation (MFN); that is, countries cannot discriminate between their trading partners. Grant someone a special favour (such as a lower customs duty rate for one of their products) and you have to do the same for all other WTO members. However, some exceptions are allowed under this principle. Countries within RTA can reduce trade barriers among themselves while discriminating against goods from outside. Or they can give developing countries special access to their markets. Or a country can raise barriers against products that are considered to be traded unfairly from specific countries.

During the fourth WTO Ministerial Conference, a new round of trade negotiations was launched in November 2001 in Doha, Qatar. The Doha negotiations were aimed at achieving major reforms of the international trading system, by lowering trade barriers and revising trade rules. The Doha Round of negotiations were expected to be concluded by 1st January 2005. However, this deadline and other subsequent ones have been missed due to divergences among the members on some of the issues under negotiations, and differences between developed countries and emerging economies, especially China, India and Brazil. Due to the slow progress in the negotiations, some issues were selected from the broader Doha Round and agreed upon during the 9th WTO Ministerial Conference held in December 2013 in Bali, Indonesia. These issues are: trade facilitation; agriculture (food security, export competition and tariff rate quota administration); development and least developed countries issues (monitoring mechanism for special and differential treatment, preferential rules of origin for LDCs, a waiver on preferential treatment to services and services suppliers of LDCs, duty-free and quota-free (DFQF) market access for LDCs and cotton).

At the 9th WTO conference, the Ministers instructed the WTO trade negotiations committee to prepare a clearly defined work programme on the remaining issues under the Doha Development Agenda by end of 2014 to set the centre stage for the final conclusion of the round. It is difficult to anticipate when the Doha Round of negotiations will be concluded.

EPAs, as a free trade agreement, are supposed to be compatible with the WTO rules. Consequently, the conclusion of the Doha Round will have an impact on EPAs in a number of ways. It was in this context that the Doha Round of negotiations was supposed to be concluded before the conclusion of EPAs (end of 2007). Due to the slow progress in the Doha Round of negotiations, this sequence seems to have been reversed - EU/EAC EPA negotiations were concluded in 2014, while the conclusion of the Doha Round is not yet known. Although the Doha Round of negotiations has not been concluded, the proposals and the convergences reached on some of the issues under discussions will have ramifications on EPAs.

On WTO RTA, there is a mandate under the Doha Round aimed at clarifying and improving disciplines and procedures under the existing WTO provisions applying to regional trade agreements. The negotiations on RTAs are also supposed to take into account the developmental aspects of RTAs. The ACP countries (Kenya included) submitted a proposal on several aspects of special and differential treatment (SDT) to be considered in the context of the RTAs negotiations. For instance, the ACP countries proposed that the threshold for substantially all trade on the basis of tariff liberalization should be 60 per cent to 65 per cent for developing countries in their arrangements with developed country members. Under EPAs, for example, the EAC will liberalize 82.6 per cent, which is higher than what has been proposed in the WTO Doha negotiations. Before the EPAs negotiations, the value of EU exports entering the EAC that had been zero rated under CET was 65.4 per cent, affecting 1,920 tariff lines. This level of market access would therefore have been sufficient for the EAC under EPA framework in line with the ACP proposal at the WTO.

The current proposed modalities for liberalization of agriculture sector under the Doha Round will also have an impact on EPAs once the Round is concluded. The EAC and EU entered into an Interim Agreement to safeguard the trade flow and market disruptions between the EAC member states and the EU upon expiry of the WTO EU-ACP waiver as at January 2007. The initialed EAC-EU Interim Agreement offers duty free market access for most export products to the EU market, among them cut flowers, fresh fruits and vegetables. However, under the Doha Round negotiations on agriculture, the tariff lines on cut flowers and fresh fruits and vegetables appear on the list of tropical products that should be zero-rated. In 2013, Kenya's exports of these products to the EU market was to the tune of US$ 400 million annually, and offers employment to more than 3 million people. The EU will also be required to reduce their MFN tariffs in other agricultural products, which will definitely erode preferences that Kenya would have secured under the EAC-EU EPA framework.

Under the Doha NAMA negotiations, sectoral approach is being pursued to achieve the overall objective of reducing or eliminating tariffs as appropriate. The tariffs in the EU for some of the sectors that have been proposed for sectoral negotiations, such as fish and fish products, and textiles and apparels, will be drastically reduced or eliminated. The EU maintains relatively high MFN tariffs in these two sectors, therefore the value of preferences given to Kenya under EPA framework will considerably be reduced or eliminated. The Doha Round will definitely be detrimental to expected gains in EPAs. In addition, the conclusion of the Doha Round will also increase competition in the EU market, and therefore Kenyan exporters to the EU market will have to be competitive in order to maintain or increase their exports to this market.

Besides preference erosion, policy space and flexibility that Kenya has negotiated under the Doha Round of negotiations will be eroded under the EPA framework. For instance, in NAMA negotiations, Kenya will be exempted from applying the proposed tariff reduction formula but will be required to increase tariff binding covered from 1.6 per cent to 75.0 per cent and achieve an average level that does not exceed 30 per cent over a period of 10 years. This will not have an impact on applied tariffs, giving Kenya an adequate policy flexibility to use tariffs as a tool for industrialization. This flexibility has been eroded under EPA framework, since Kenya will be expected to reduce its applied tariff on EU imports, which is likely to affect domestic industries through increased competition.

4.3 Economic Implications of EPAs to Kenya

4.3.1 Descriptive statistics

In 2013, imports into Kenya from the EU were about Ksh 100 billion, and spread across various product categories as indicated in Figure 4.1. The bulk of the imports were chemical products under chapter 28-38 (Appendix Table A5 for product categorization) of the HS tariff classification, which amounted to about Ksh 37.5 billion or 37 per cent of total imports during the year. The other significant imports were mineral products under chapters 25-27 (12%), and those under chapters 72-97 including base metals and transport and communications (10%).

In terms of import origins, Figure 4.2 shows the origin countries according to various product categories. Although the import origins are mixed, the EU is the largest exporter of products under chapter 71 to Kenya, which includes natural or cultured pearls, precious or semi-porous stones, while the ACP group remains the biggest exporter to Kenya for products under chapters 16-24 (prepared foodstuffs, beverages, spirits and vinegar, tobacco) and 41-43 (raw hides and skins, leather, fur skins and articles thereof), while the remaining products from the ROW dominated the other imports.

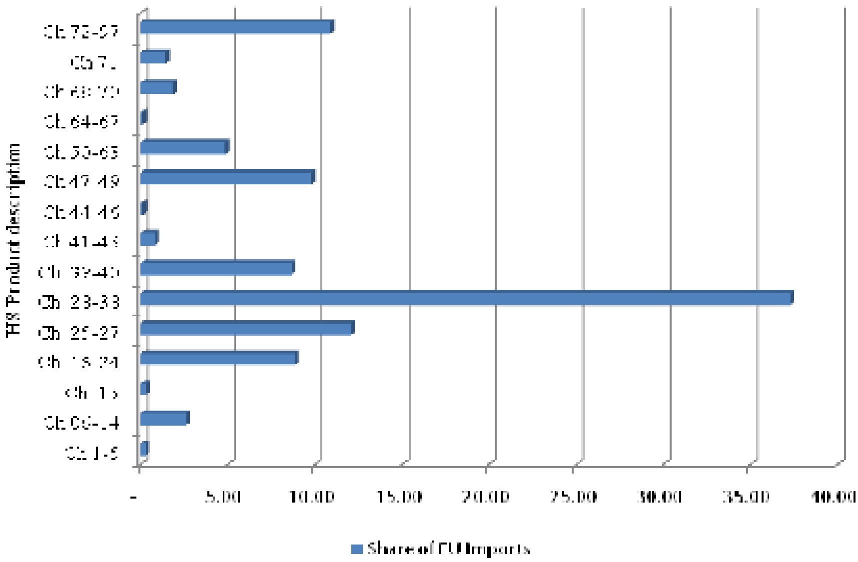
4.3.2 Simulation results

The simulations are carried out in three phases:[8]

1. The first phase is liberalization during the first year into the EPAs. During this phase, the tariffs for products under Appendix IIB are reduced by 20 per cent; that is from 10 per cent to 8 per cent, while those under annex IIC are reduced by 5 per cent; that is from 25 per cent to 23.8 per cent.
2. The second phase will take place after 8 years into the EPAs, when tariffs for products under Annex IIB are reduced by 100 per cent to zero, while those under Appendix IIC are reduced 20 per cent.
3. The final phase is where the products under Annex IIC of the schedule are reduced to zero and upon which liberalization will cover 82.6 per cent of the tariff lines.

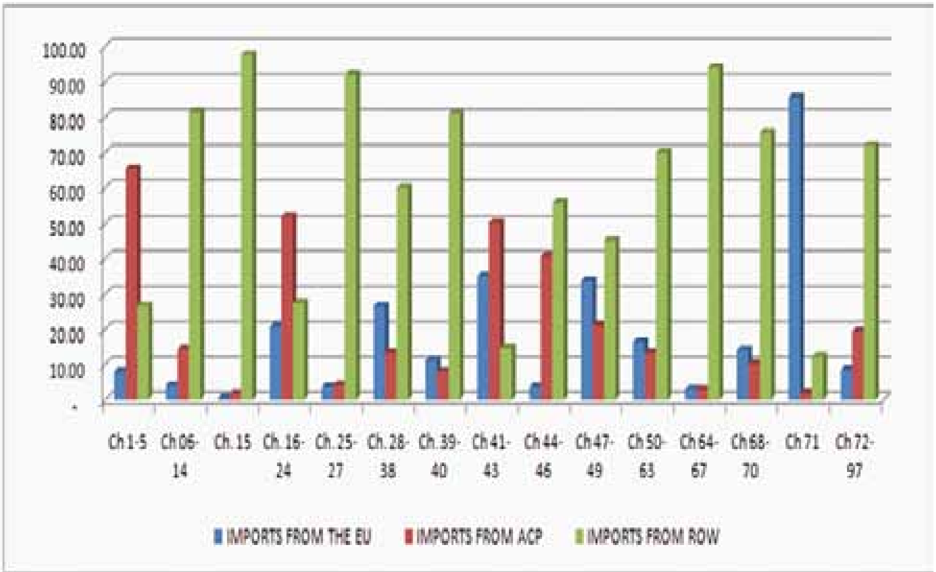
[8] See Products under Annexes IIB and IIC of the final EAC-EPA.

Figure 4.1: Percent share of imports from the EU by product in 2013



Source: Authors' calculations from KRA data

Figure 4.2: Share of imports per product origin during 2013



Source: Authors' compilations

Tariff revenue effects

This is estimated for those sectors where the EU is the globally efficient and a dominant supplier to the EAC region. The results indicate that there will be gradual reductions in tariff revenues following gradual reduction of tariffs as per the schedule for liberalization. Thus, total tariff revenues will reduce from Ksh 9.8 billion to Ksh 9.4 billion during the first phase (year) of liberalization and to Ksh 7.9 billion during the second phase of liberalization, and to Ksh 6.8 billion during the last phase of liberalization. The revenue losses due to the first phase of liberalization would be about Ksh 362 million (from the baseline data)

Detailed revenue losses by products are presented in Figure 4.3. The figure indicates the revenue collections from the baseline scenario and during the 3 phases of liberalization. For instance, during the first phase, the products under chapters 25-27, 72-97, 28-38 and 47-49 incurred 33, 19, 17 and 15 per cent revenue reductions, respectively.

The potential revenue effects after full implementation of the agreement are in Figure 4.4. In that case, the products in chapter 72-97, which include base metals, machinery, vehicles and transport equipment, arms, and opticals, would have the largest revenue reductions of 33 per cent. The others would be chapter 25-27 (24%) and chapters 47-49 (16%).

Trade creation effects

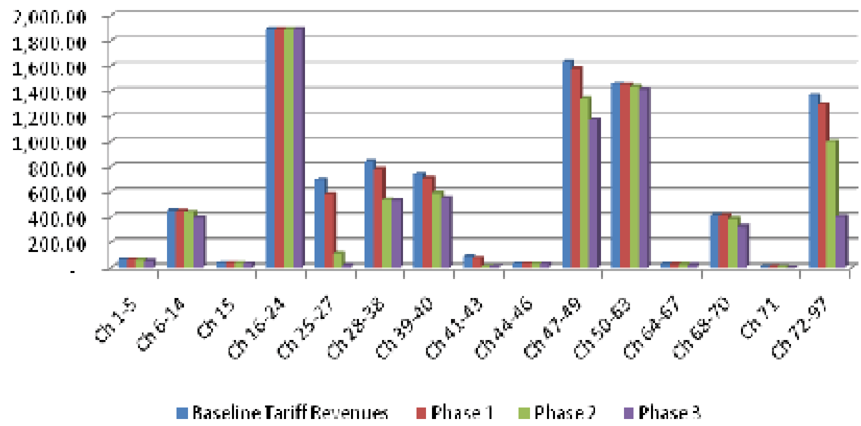
Assuming the EU is a more efficient supplier than ROW, all current imports from the ROW would be replaced by more efficient production from the EU. As a result

Table 4.1: EPA revenue effects for Kenya (Ksh million)

Chapter	Baseline Tariff Revenues	Phase 1	Phase 2	Phase 3
Ch 1-5	66.30	65.71	64	54
Ch 6-14	452.79	449.77	440	397
Ch 15	38.11	37.94	37	36
Ch 16-24	1,894.42	1,894.41	1,894	1,894
Ch 25-27	699.20	581.31	115	16
Ch 28-38	842.00	781.01	537	533
Ch 39-40	741.28	710.84	590	549
Ch 41-43	90.04	74.06	10	10
Ch 44-46	34.06	33.91	33	33
Ch 47-49	1,633.38	1,577.69	1,340	1,172
Ch 50-63	1,459.31	1,454.39	1,438	1,415

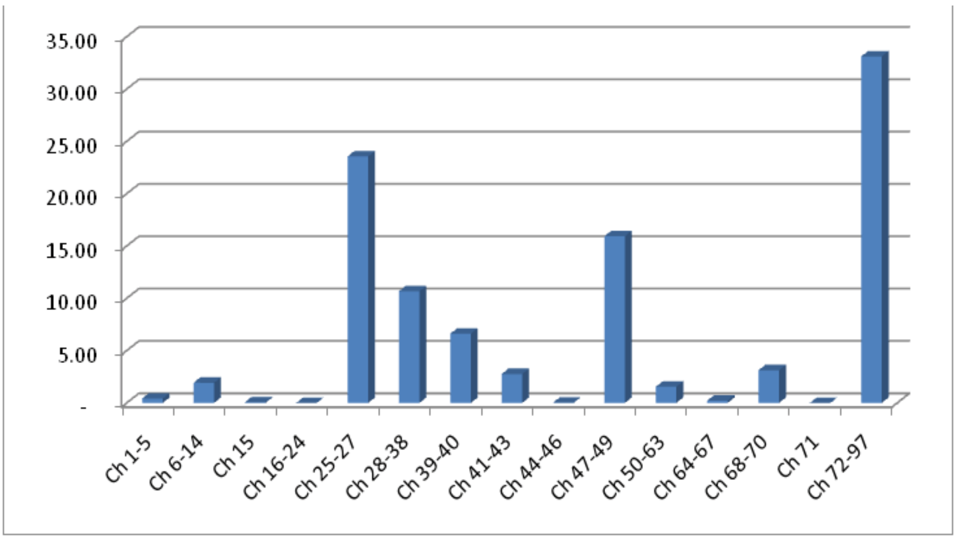
Ch 64-67	28.52	27.99	26	22
Ch 68-70	415.82	413.04	388	325
Ch 71	9.69	9.23	8	-
Ch 72-97	1,365.52	1,297.18	999	406
Total	9,770.44	9,408.48	7,921	6,863

Figure 4.3: Tariff revenues changes (value in Ksh millions)



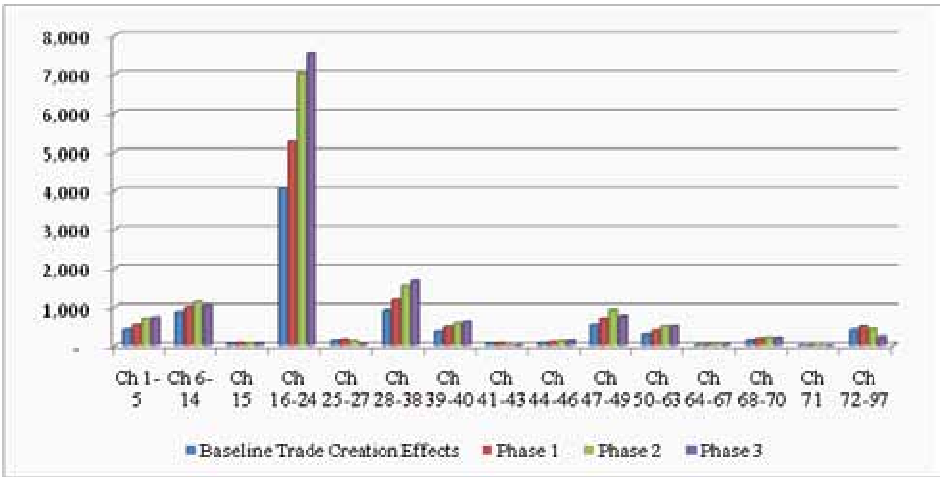
Source: Authors' simulations

Figure 4.4: Reduction of revenues after full implementation (%)



Authors' simulations

Figure 4.5: Trade creation effects



Authors' simulations

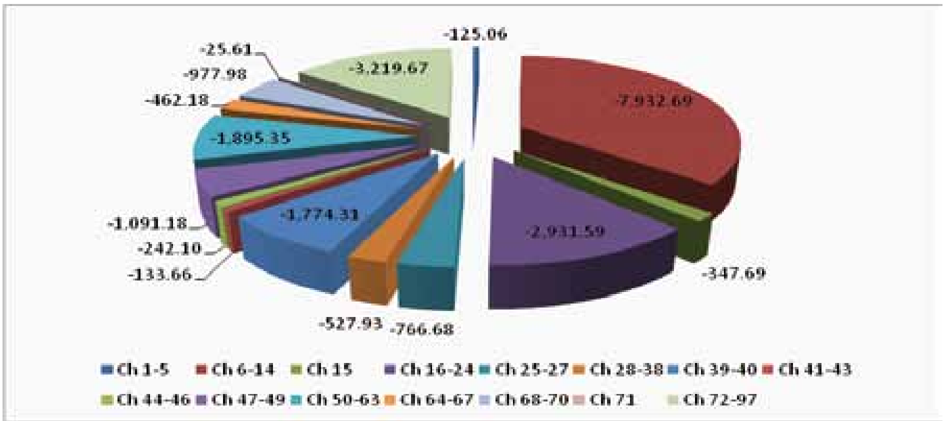
of tariff reductions, increased imports from the EU would be realized from the initial value of about Ksh 8.3 billion increases to Ksh 10.7 billion and Ksh 13.4 billion during the first phase and second phase of liberalization, respectively (Figure 4.5).

The bulk of trade creation would be derived from the products under chapters 16-24 (53%), 28-38 (12%) and 6-14 (5%) during phase one of liberalization. The largest increase in trade creation in phase one and two of liberalization will occur for prepared foodstuffs, beverages and mineral products (Chapters 16-24) and products of chemical or allied industries (Chapters 28-38), respectively. It is also noted that there are reductions in trade under some category of products; that is under chapter 71 of the product classifications during phase one of liberalization. On the other hand, the second phase of liberalization leads to reduction in trade creation with the EU for products under chapters 25-27; that is, mineral products and 41-43 or raw hides and skins, leather, fur skins and articles thereof, while the third phase of liberalization sees a significant reduction in trade for products under chapters 72-97 and chapter 71.

Trade diversion

These are effects when there is a shift of imports from the more efficient ROW producers to the EU region as a result of tariff phase-down in favour of EU producers. Since the tariff on products remains unchanged from the baseline levels, the estimates given are indicative of the largest effects possible given the

Figure 4.6: Trade diversion effects



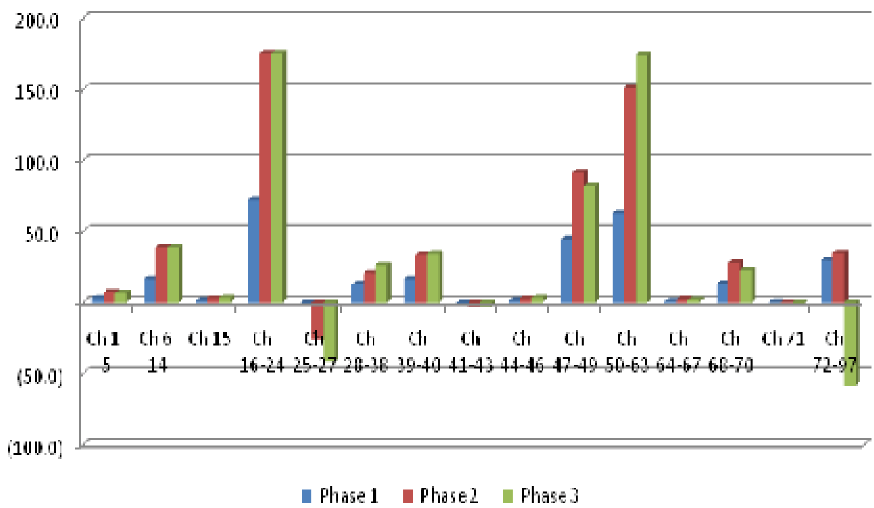
baseline figures. The biggest effects occur in chapters 6-14 (35%), 72-97 (14%) and 16-24 (13%).

Considering that the value of Kenya's imports from the EU was Ksh 100.6 billion (Figure 4.6), the value of trade diverted from more efficient suppliers to the Kenyan market to the EU is about 22.3 per cent.

Welfare effects

This constitutes consumption effects arising from trade creation and trade diversion effects. The biggest net welfare effects take place during phase 2 of liberalization, whereby the net effect of about Ksh 560 million (Figure 4.7) are derived. During the time, the largest welfare gains are derived from products under chapters 16-24; that is, prepared food stuffs, beverages, spirits, vinegar, tobacco; and 50-63 (textiles and textile articles), showing the importance of these products to the Kenyan economy.

Figure 4.6: Change in welfare effects during liberalization (Ksh Millions)



Source: Authors' simulations

5. Conclusions and Policy Recommendations

5.1 Conclusions

Kenya's exports to the EU market are dominated by a narrow range of primary commodity exports that include cut flowers, tea, coffee, vegetables and fish. Given that most of these exports are mainly agricultural commodities, increased exports in this area will depend on how Kenyan exporters are able to meet technical standards. There is a likelihood of sanitary and phytosanitary (SPS) escalation, including private standards in the EU market.

The perceived preference margins that Kenya is to enjoy with the conclusion of EPAs are declining and will continue to decline in the future because of two reasons. First, the EU has already concluded trade negotiations or is under negotiation with other countries/regions. A case in point is the already concluded FTA agreement between the EU and Colombia, which is also a major producer of cut flowers as Kenya. This agreement has the potential to eat into Kenya's cut flower exports to the EU in future, given that Colombia exported cut flowers worth approximately US$ 156 million, which is about 11 per cent of EU's cut flower imports without preferential treatment. With the signing of the agreement, Colombia's share of cut flower exports to the EU might increase significantly and reduce Kenya's share of exports to the EU, which stood at 37 per cent (approximately US$ 495 million worth of exports) in the presence of preferential market access. Second, multilateral trade liberalization under the WTO implies continued decline of tariffs and other trade barriers in the future. Thus, with or without an agreement at multilateral level in the immediate future, preference erosion is unavoidable over time. In this regard, the EPAs will only provide a temporary advantage to Kenya in terms of market access for some products.

The conclusion of EPAs will mainly serve to preserve current market access by Kenya in the EU and avoidance of market disruption. As such, no substantial market access improvement can be anticipated by Kenya because its products already enter the EU market DFQF under the interim EPAs. This is unless market supply constraints are addressed and export capacity is developed in the short, medium and long-term.

The degree to which Kenya benefits will be dependent upon the degree of Kenya's supply-side flexibility, flexibility of the rules of origin (RoO) already negotiated, the extent of NTBs especially SPS norms, and the scope and levels of economic and development cooperation.

With regard to the outstanding issues under EPAs, such as export taxes, domestic and export subsidies and reference to the Cotonou Agreement, some of them contradict WTO rules. For instance, export taxes are a policy instrument allowed under WTO, while domestic support and export subsidies are under negotiations as part of the Doha round. The EAC countries can consider enumerating products for which they can consider to be important for industrialization, and where export taxes can be imposed. In the case of domestic support and export subsidies, they should be dealt with at the WTO, since EAC countries will not have the capacity to monitor them at the EU, and the EU will find it difficult to discriminate in favour of the EAC when imposing them. Issues to do with governance, human rights and the like can be dealt with by both domestic and international laws and institutions.

Even with the signed EPAs, the conclusion of the WTO Doha Round will definitely be detrimental to the expected gains from EPAs. In addition, the conclusion of the Doha Round will also increase competition in the EU market. Therefore, Kenyan exporters to the EU market will have to be competitive in order to maintain or increase their exports to this market.

Besides preference erosion, policy space and flexibility that Kenya has negotiated under the Doha Round of negotiations will be eroded under the EPA framework.

Kenya/EAC have already lost policy space and flexibilities accorded in the WTO within the EPA framework. This is because Kenya had proposed between 60-65 per cent liberalization of trade when negotiating with the advanced countries as being adequate in meeting the threshold set by the WTO. Contrary to this, under EPA, Kenya has gone beyond its threshold and liberalized 82.6 per cent of trade with the EU.

Although the simulation results show loss of tariff revenue as a result of trade liberalization, these are compensated for through net welfare gains as a result of reduced consumer prices and also increased trade creation. Besides, the importance of tariff revenues as a share of government revenue has been declining over time following diversification of sources of government revenue. In addition, some of the imported products also attract domestic taxes such as VAT and excise duties. The results indicate overall welfare gains with the conclusion of EPAs.

Overall, Kenya has to work on its competitiveness in order to retain and benefit from trade agreements such as the EPAs. This is because tariff and other trade barriers are decreasing over time in the international markets.

5.2 Recommendations

In order for Kenya to benefit fully from EPAs, there is need to, among other things, urgently address supply-side constraints such as inadequate infrastructure, and low productive capacity of producers which limit exportable surplus. Specifically, Kenya should begin with upgrading the Mombasa port to allow bigger vessels to call at the port and enhance trade. The country needs to implement installation of an oil pipeline from Nairobi to Eldoret to increase pumping capacity. Moreso, construction of the power transmission line from Kenya to Ethiopia should be completed to increase power supply to the Kenya national grid. The establishment of SME parks should be looked into so as to aid development of infrastructure and amenities for industries and FDI in Kenya.

As a way of addressing the lack of familiarity with the measures and implementation of ISO 22000 (food safety management), there is need for the country to build capacity for the fish SPS measures. Finally, the country and the region need to tighten the institutional and regulatory framework of regional standards for commodities. Thus, the conclusion of EPAs should be accompanied by a comprehensively negotiated financial facility under the development component to address issues of competitiveness. This is also due to the fact that there is a great divergence between the EU and the ACP countries in terms of the level of development, and thus trade relation between them should be asymmetric. The EU trade preferences to ACP countries and Kenya should enhance export growth and diversification from limited primary and natural resource-based commodities.

Some of the sectors that Kenyan producers can have quick wins include horticulture, leather, fisheries, cotton, honey and apparels and clothing. The European Development Fund (EDF) should be directed towards these sectors.

Kenya should urgently embark on an industrialization strategy to diversify exports, especially high technology exports. This can be done by seeking new markets for our traditional products, adding value to traditional products and selling them to existing trade partners, or creating new products to be sold in the non-traditional markets. Some of the key products in the EU market include horticulture, tea, coffee, leather, fish, spices, non-ferrous metals and children's toys and games. The country could, for example, begin by adding value to the horticultural products and selling them to the traditional markets such as the EU, then seek new markets in other large horticultural importing countries such as China, USA and Canada. The country could also diversify by venturing into the production of textiles and articles of apparel. This has been identified as a high potential growth area in terms of exports, and it uses labour-intensive production strategy that is advantageous to Kenya. A ladder-like approach should be adopted where, at the initial stage, sectors to pioneer the process of industrialization should be those that use the abundant factors of production already available in Kenya, for example labour. Such sectors include ICT and pharmaceuticals.

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Appendix

Appendix 1: List of EAC exclusion list

Live animals; meat and edible meat offal; fish and crustaceans, molluscs and other aquatic invertebrates; dairy produce; birds' eggs; natural honey; edible products of animal origin; live trees and other plants; bulbs, roots and the like; cut flowers and ornamental foliage; edible vegetables and certain roots and tubers; edible fruit and nuts; peel of citrus fruits or melons; coffee, tea, maté and spices; cereals; products of the milling industry; malt; starches; vegetable plaiting materials; vegetable products n.e.s.; animal or vegetable fats and oils and their cleavage products; prepared edible fats; animal or vegetable waxes; preparations of meat, of fish or of crustaceans, molluscs or other aquatic invertebrates; sugars and sugar confectionery; cocoa and cocoa preparations; preparations of cereals, flour, starch or milk; pastry cooks' products; preparations of vegetables, fruit, nuts or other parts of plants; miscellaneous edible preparations; beverages, spirits and vinegar; residues and waste from the food industries; prepared animal fodder; tobacco and manufactured tobacco substitutes; plastics and articles thereof; wood and articles of wood; cotton; man-made filaments; man-made staple fibres; footwear, gaiters and the like; parts of such articles; iron and steel; and articles of iron or steel.

Table A1: EAC/Kenya market access offer to the EU

	No. of lines	**Import value, average (2004-2006)**		**MFN**			
		in US $ 000	**Share of total**	**Min.**	**Max.**	**Simple average**	**Trade weighted**
Total trade HS 1-97		1,214,717	100.00				
Of which in codes listed in EAC schedule		1,214,469	99.98				
In codes missing from EAC schedule		248	0.02				
Goods to be liberalized							
2015-2020	1,950	610,498	50.30	0	0	0.0	0.0
2020-2028	1,129	314,330	25.90	10	25	10.1	10.0
2028-2041	960	72,418	6.00	25	25	25.0	25.0
Excluded goods	1,390	217,223	17.90	10	100	24.8	27.5
Total	5,429	1,214,469	99.80				

Source: Calculations from EAC tariff book, 2010/EAC secretariat

Table A2: African countries that have signed or not signed an EPA

Negotiating Region	LDCs and non-LDCs that have signed an EPA	LDCs that have not signed an EPA (export to EU under EBA or Market Access Regulation (MAR 1528/2007)	Non-LDCs that have not signed an EPA
Central Africa	Cameroon (Signed on 26 November 2008; exports to EU under MAR 1528/2007)	Central African Rep., D.R. Congo, Chad, Equatorial Guinea, Sao Tome	Gabon (MFN), Rep. Congo (GSP)
East African Community	Signed in October 2014	Burundi, Rwanda, Tanzania, Uganda – initialed	Kenya – initialed (exports to EU under MAR 1528/2007)
Eastern and Southern Africa (ESA)	Mauritius, Seychelles, Zimbabwe, Madagascar (All above signed on 29 August 2009; Exports to EU under EPA)	Djibouti, Eritrea, Ethiopia, Malawi, Somalia, Sudan, Comoros, Zambia – initialed	
West Africa	Cote d'Ivoire (Signed on 26 November 2008; Exports to EU under MAR 1528/2007)	Benin, Burkina Faso, The Gambia, Guinea, Guinea Bissau, Liberia, Mali, Mauritania, Niger, Senegal, Sierra, Leone, Togo	Ghana – initialed (exports to EU under MAR 1528/2007) Nigeria (GSP) Cape Verde (GSP+)
SADC	Botswana, Swaziland, Lesotho signed on 4 June 2009, Mozambique signed on 15 June 2009 (All export to EU under MAR 1528/2007)	Angola	Namibia – initialed (exports to EU under MAR 1528/2007)

Source: European Parliament, 2014; and KRA 2013 Data

Table A3: Kenyan export commodities to the EU (2013)

	Article (SITC)	Product Description	Value (Ksh)	Share of Total (%)	Cumulative Share (%)
1	292	Crude vegetable materials, n.e.s.	34,145,882,487	31.41	31.41
2	054	Vegetables, fresh, chilled, frozen or simply preserved (including dried leguminous vegetables); roots, tubers and other edible vegetable products, n.e.s., fresh or dried	18,382,113,500	16.91	48.32
3	074	Tea and mate	16,792,634,907	15.45	63.76
4	071	Coffee and coffee substitutes	14,397,044,882	13.24	77.00
5	292	Crude vegetable materials, n.e.s.	3,679,298,259	3.38	80.39
6	058	Fruit, preserved, and fruit preparations (excluding fruit juices)	3,434,566,046	3.16	83.55
7	278	Other crude minerals	2,982,063,595	2.74	86.29
8	056	Vegetables, roots and tubers, prepared or preserved, n.e.s.	2,389,736,947	2.20	88.49
9	057	Fruit and nuts (not including oil nuts), fresh or dried	2,336,818,193	2.15	90.64
10	034	Fish, fresh (live or dead), chilled or frozen	1,379,185,252	1.27	91.91
11	611	Leather	1,297,645,079	1.19	93.10
12	037	Fish, crustaceans, molluscs and other aquatic invertebrates, prepared or preserved, n.e.s	1,268,767,833	1.17	94.27
13	059	Fruit juices (including grape must) and vegetable juices, unfermented and not containing added spirit, whether or not containing added sugar or other sweetening matter	1,192,981,764	1.10	95.36
14	121	Tobacco, unmanufactured; tobacco refuse	844,461,993	0.78	96.14
15	894	Baby carriages, toys, games and sporting goods	582,828,948	0.54	96.68
16	075	Spices	491,663,626	0.45	97.13

17	098	Edible products and preparations, n.e.s.	255,669,567	0.24	97.36
18	036	Crustaceans, molluscs and aquatic invertebrates, whether in shell or not, fresh (live or dead), chilled, frozen, dried, salted or in brine; crustaceans, in shell, cooked by steaming or bo	224,592,695	0.21	97.57
19	288	Non-ferrous base metal waste and scrap, n.e.s.	220,953,595	0.20	97.77
20	265	Vegetable textile fibres (other than cotton and jute, raw or processed but not spun; waste of these fibres	162,094,047	0.15	97.92
21		All Others	2,257,784,198	2.08	100.00
		Total	108,718,787,413		

Source: KRA and Authors' Computation

Table A4: Kenyan import commodities from the EU (2013)

	Article (SITC)	Product Description	Value (Ksh)	Share of Total (%)	Cumulative Share (%)
1	783	Road motor vehicles, n.e.s.	12,026,583,475	5.89	5.89
2	542	Medicaments (including veterinary medicaments)	7,925,664,579	3.88	9.77
3	641	Paper and paperboard	7,548,411,951	3.70	13.47
4	764	Telecommunications equipment, n.e.s., and parts, n.e.s., and accessories of apparatus falling within division 76	6,729,520,218	3.30	16.77
5	792	Aircraft and associated equipment; spacecraft (including satellites) and spacecraft launch; and parts thereof	6,364,111,383	3.12	19.89
6	781	Motor cars and other motor vehicles principally designed for the transport of persons (other than public-transport type vehicles) including station wagons and racing cars	6,012,542,912	2.95	22.83
7	713	Internal combustion piston engines, and parts thereof, n.e.s.	5,346,288,497	2.62	25.45

8	098	Edible products and preparations, n.e.s.	5,175,373,719	2.54	27.99
9	716	Rotating electric plant and parts thereof, n.e.s.	5090391658	2.49	30.48
10	334	Petroleum oils and oils obtained from bituminous minerals (other than crude); preparations, n.e.s. containing by weight 70% or more of petroleum oils or of oils obtained from bituminous minerals	4831322773	2.37	32.85
11	562	Fertilizers (other than those of group 272)	4,820,127,895	2.36	35.21
12	728	Other machinery and equipment specialized for particular industries, and parts thereof, n.e.s.	4,164,305,601	2.04	37.25
13	745	Other non-electrical machinery, tools and mechanical apparatus, and parts thereof, n.e.s.	3,829,414,056	1.88	39.12
14	269	Worn clothing and other worn textile articles; rags	3,739,617,203	1.83	40.96
15	541	Medicinal and pharmaceutical products, other than medicaments of group 542	3,736,245,076	1.83	42.79
16	591	Insecticides, rodenticides, fungicides, herbicides, anti-sprouting products and plant-growth regulators, disinfectants and similar products, put up in forms or packings for retail sale or	3,540,990,674	1.73	44.52
17	752	Automatic data processing machines and units thereof; magnetic or optical readers, machines for transcribing data onto data media in coded form and machines for processing such data, n.e.	3,207,544,833	1.57	46.09
18	598	Miscellaneous chemical products, n.e.s.	3,055,733,968	1.50	47.59

19	772	Electrical apparatus for switching or protecting electrical circuits or for making connections to or in electrical circuits; electrical resistors, other than heating resistors; printed boar	2,969,980,529	1.45	49.04
20	782	Motor vehicles for the transport of goods and special purpose motor vehicles	2,875,744,775	1.41	50.45
21		All Others	101,143,055,026	49.55	100.00
		Total	**204,132,970,801**		

Table A5: Product categorization by Chapters

	Chapters	Product descriptions
1	1-5	Live animals, animal products
2	6-14	Vegetable products
3	15	Animal or vegetable fats and oils and their cleaverage products
4	16-24	Prepared foodstuffs, beverages, spirits and vinegar, tobacco
5	25-27	Mineral products
6	28-38	Products of chemical or allied industries
7	39-40	Plastics and articles thereof, rubber and articles thereof
8	41-43	Raw hides and skins, leather, furskins and articles thereof
9	44-46	Wood and articles of wood, wood charcoal, cork and articles of charcoal
10	47-49	Pulp of wood or other fibrous cellulosic material, paper or paper boards
11	50-63	Textiles and textile articles
12	64-67	Footwear, headgear, umbrellas, walking sticks
13	68-70	Articles of stone, plaster, cement, asbestos, mica or similar materials
14	71	Natural or cultured pearls, precious or semi-porous stones
15	72-97	Base metals, machinery, vehicles & transport equipment, arms, optical, etc.

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