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VISION: To be the leading public policy research institute in Africa, an international centre of excellence

MISSION: To provide quality public policy advice to the Government of Kenya by conducting objective research and analysis and through capacity building in order to contribute to the achievement of national development goals

In this Issue

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Kenya's Participation in International Trade Negotiations

Eric Ronge and Hezron Nyangito

Kenya has pursued global integration through trade with other countries at regional and international level. The main aim in the various trade negotiations has been to increase market access for Kenya's products and to protect Kenya's regional markets, especially by addressing the issues of taxes on imports and exports, and the market-distorting subsidies in products of interest to Kenya.

Trade negotiations play a key role in increasing international market access for exports. Kenya has signed various bilateral, multilateral and regional agreements that also obligate her to increase access to her market in return. The main trade agreements are the European Union (EU)-African Caribbean and Pacific (ACP), and the WTO trade agreements. Kenya is also a member of the East African Community (EAC) and the Common Market for Eastern and Southern Africa (COMESA), which allow for preferential access in regional trade. The more immediate concern for Kenya within the East African Community and COMESA is the need to rationalize the country's participation in different trading arrangements in the region.

This article evaluates the status of various trade agreements Kenya is involved in, and identify the challenges and risks in each of the trade agreements.

Barriers to trade

Most countries protect their domestic markets by restricting international trade using both tariff and non-tariff barriers to trade. Under the multilateral trade system symbolised by the World Trade Organization (WTO), trade negotiations seek to generally achieve commitments among member countries to liberalize their trade by lowering tariffs on the *Most Favoured Nation (MFN)* basis and to eliminate non-tariff barriers through tariffication. The MFN principle simply requires countries to extend to all other WTO members any tariff concession extended to any one member. The tariff concessions made during the General Agreement on Tariffs and Trade (GATT) and WTO trade negotiations by one country are made in return for similar actions by other countries.

Trade agreements, whether bilateral, multilateral or regional, essentially seek to establish rules that enable participating countries to achieve sustained

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Editorial

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The *KIPPRAPolicy Monitor* is back after missing for several quarters due to unavoidable circumstances. We therefore have great pleasure to deliver to you, our dear reader, this issue of the *KIPPRA Policy Monitor* covering the period April 2004 to June 2005. During the period, the Institute held a conference on improving the enabling environment for business in Kenya, in January 2005; started preparation of an external aid policy for Kenya, which is still on-going; and prepared for the government a report on the potential impact of Economic Partnership Agreements (EPAs) on the Kenyan economy. The enabling environment conference, in particular, was a great success and its products were used to brief the government on requisite strategies for creating an enabling environment for business in Kenya.

During the period, the Institute prepared various briefs to the National Economic and Social Council (NESC). The Institute also prepared, in partnership with Ernst and Young (a private sector company), a bid proposal on a simplified registration and taxation system for micro and small enterprises. This bid was submitted to the Ministry of Trade and Industry and the World Bank. The Institute also organized a conference on illicit trade in East Africa. During the annual work plan retreat in March 2005, the Institute reviewed its activities for the year 2004/5 and also prepared a work plan for the year 2005/6. The theme for the 2005/6 work plan will be on competitiveness. It is expected that a national conference on this theme will be organized towards the end of the plan year.

Apart from policy research and analysis, other major milestones at the Institute included the preparation of a Performance Contract between the Institute and the Government of Kenya, to be implemented from July 2005.

This issue of the *Kippra Policy Monitor* highlights these and other exciting moments and achievements, and the challenges the Institute had to grapple with. The Executive Director amplifies on the achievements and experiences of the Institute during the period and reflects on the challenges in influencing policy formulation. As usual, the issue presents a concise analysis of the country's economic performance during the period and an outlook into the next year.

The lead article is on trade and trade negotiations. The most important issue the country is grappling with currently is that of negotiating varied trade and regional integration agreements, ranging from regional agreements such as the East African Community Customs Union to multilateral ones like the World Trade Organization agreements. The article describes the state of play of the various negotiations Kenya is involved in, with particular focus on the challenges and risks involved and the options Kenya has to evaluate in the various trade arrangements.

We, at the *Kippra Policy Monitor*, continue to gain wisdom and draw great encouragement from the feedback we get from you, our dear reader. We are very grateful for these comments and urge you to continue sending them to us through monitor@kippra.or.ke or through the Institute's other channels of communication.

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The Kenya Institute for Public Policy Research and Analysis (KIPPRA) is an autonomous institute whose primary mission is to provide quality public policy advice to the Government of Kenya by conducting objective research and analysis, and through capacity building in order to contribute to the achievement of national development goals. KIPPRA serves as a centralized source from which the government and the private sector can obtain information and advice on public policy issues.

KIPPRA acknowledges generous support from the European Union (EU), the African Capacity Building Foundation (ACBF), the United States Agency for International Development (USAID), the Department for International Development of the United Kingdom (DfID), International Development Research Centre (IDRC), the Government of Kenya, among other development partners and organisations.

INSTITUTE INTENSIFIES DISSEMINATION OF POLICY RESEARCH AND ANALYSIS

Dr Hezron Nyangito
Executive Director, KIPPRA

The aim of policy research and analysis is to assist and advise policy makers in order for them to make better policies. Therefore, for policy research findings to be useful, they must be effectively passed on to policy makers. Further, the findings should be able to promote policy dialogue in order to lead to adoption or implementation of new and improved prescriptions. The role of policy analysis, and therefore policy research institutions, goes beyond research to include marketing of the research, the findings and the policy recommendations. The Kenya Institute for Public Policy Research and Analysis (KIPPRA) takes cognizance of this fact in its work and believes in engaging various stakeholders in policy dialogue. The Institute has continued to sharpen its approaches and the models it uses to engage in policy dialogue with stakeholders. A number of initiatives habe been taken in the last six months towards this end, as illustrated in the following examples

Improving the enabling environment for doing business

KIPPRA has over the last two years undertaken research on strategies for enhancing the enabling environment for doing business in Kenya, with a focus on the policy, legal and regulatory reforms. As a way of engaging various stakeholders in policy dialogue on these issues, the research results were presented at a conference on Improving the Enabling Environment for Doing Business in Kenya, held on the 20th of January 2005. The main objective of the conference was to disseminate the research findings to the government, private sector, civil society and development partners, and allow the participants to discuss and make recommendations on how the enabling environment for doing business in Kenya could be enhanced to contribute towards employment and wealth creation.

His Excellency Hon. Dr. Moody Awori (EGH, EBS, MP) Vice President of the Republic of Kenya and Minister for Home Affairs was the Chief Guest during the conference, which was also attended by the Minister for Planning and National Development Hon. Peter Anyang' Nyong'o (EGH, MP) and other senior Government officers including Permanent Secretaries Dr. N. Ng'eno of the Ministry of Trade and Industry, Mr. David Nalo of the Ministry of Planning and National Development, Mrs D. N. Angote of the Ministry of Justice and Constitutional Affairs, Prof. Khorda of the Ministry of Water and Irrigation and Mr. M. Maalim of the Office of the Vice President and Ministry of Home Affairs. Over 200 participants from the public and private sectors attended the conference.

Analysis by KIPPRA has shown that the environment for doing business in Kenya is characterized by high costs of doing business and relatively fewer incentives compared to neighboring countries. As a result, competitiveness in both the domestic and export markets have been seriously eroded, thereby adversely affecting growth of the private sector. A better investment climate for businesses requires better macroeconomic stability and management, availability and access to financial services, better infrastructure to reduce costs, improved human capital to enhance labor productivity, better security of persons and property, management of the environment and resources and good governance of both public and private affairs.

The Vice President observed that policy makers and implementers should adopt a proactive and aggressive approach in the management of public policy. The responsible agencies identified for implementation of various policies related to the enabling environment should move fast in implementing development programs so as to tackle the perennial problem of slow program implementation. Further, reform programs should be fast-tracked to address the regulatory, legal and institutional weaknesses. The recommendations arising from the conference were synthesized by KIPPRA and forwarded to the Cabinet through the Ministry of Planning and National Development to assist in policy formulation.

Urban and regional planning initiative

The Institute also held a national conference on Urban and Regional

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Planning as an Instrument for Wealth and Employment Creation. The main objective of the conference, held from 2-3 February 2004, was to identify the factors that have led to ineffective urban and regional planning and suggest policy proposals to reverse the situation. The Chief Guest during the Conference was Hon. Prof. Peter Anyang' Nyong'o (EGH, MP), Minister for Planning and National Development.

The preparation of the conference was unique in that it was organized by KIPPRA in very close collaboration with key stakeholders from Government, through an inter-ministerial task force involving the Ministry of Planning and National Development, Local Government, Regional Development Authorities, Lands and Housing, and Office of the President. Consultations were also undertaken with the National Environmental Management Authority (NEMA), the City Council of Nairobi, the civil society, and the private sector. Over 150 stakeholders from government (including Ministers and Permanent Secretaries), the private sector, and civil society attended the conference.

The proposals made by participants towards making Kenya a planning society revolved around a strong but realistic vision for urban and regional planning; effective policies, laws and institutions; and a well-coordinated urban and regional planning practice. The recommendations resulted in a Cabinet Memo by KIPPRA, which was forwarded to the Cabinet through the Ministry of Planning and National Development.

Illicit trade in East Africa

A conference on illicit trade in East Africa was held on 6th May 2005. The conference was sponsored by BAT East Africa and Eveready East Africa with participants from Kenya and Uganda government ministries and departments, revenue authorities and enforcement agencies (police, customs, standards), and observers from Tanzania, Rwanda and the Democratic Republic of Congo. A total of 120 participants attended the conference.

The Chief Guest was Hon. David Mwiraria, EGH, MP, Minister for Finance Kenya. The speakers included the Minister of State for Finance-Uganda, CEOs and officials from participating firms, EAC Secretariat officials, revenue authority officials, enforcement agents including the Kenya Police, Kenya Administration Police, Kenya Bureau of Standards, Kenya Industrial Property Institute, Kenya Association of Manufacturers and Uganda Manufacturers' Association.

The conference discussed the nature, causes, actors, magnitude and impact of illicit trade in East Africa and the Great Lakes region. KIPPRA and the Economic Policy Research Center (EPRC) of Uganda presented the main issues of concern while presentations from industry, government departments of the represented countries in charge of taxes and duties, and legal and regulatory environment highlighted the state of illicit trade in the region.

Participants acknowledged that illicit trade has made the region unattractive to investors. Governments from the East African region are committed to eradicating the vice by, among other things, reviewing the policy, legal and institutional framework, and harmonizing external tariffs within the EAC to minimize illicit trade due to tariff differentials. Industry players, manufacturers' associations and enforcement agents underscored the need for public-private-partnership in addressing the vice. The recommendations from the conference were synthesized and distributed to all relevant government departments involved in trade, and all stakeholders who attended the conference.

The lesson learnt from these conferences organized by the Institute is that influencing policy formulation and implementation requires working with diverse stakeholders with different interests. The challenge is how to market the research findings and involve a diverse range of stakeholders and interests. However, KIPPRA has developed a wide range of mechanisms of working with diverse clients, with focus on objectivity in policy work and providing options for specific policy problems without fear or favor.

Minister for Finance, Hon. David Mwiraria during the opening of the KIPPRA/BAT conference on illicit trade in East Africa, held at the Windsor Golf and Country Club in May 2005. With him are Dr Nyangito, Executive Director KIPPRA, and Dr Nehemiah Ng'eno, Permanent Secretay, Ministry of Trade and Industry

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reciprocal trade liberalization. Such rules restrict the conduct and scope of member countries' trade policies and as a result improve predictability of trade regimes. As such, and almost without exception, trade agreements are structured in such a way that participating countries can achieve two basic objectives, namely: enforce mutual commitments to reduce trade barriers between them, and provide permissible exceptions from these commitments. These basic objectives allow countries to engage in different trade agreements and to defend certain strategic sectors that may be threatened by these agreements.

The WTO seeks, under the overarching 'Most Favoured Nation' and 'National Treatment' principles, to remove any form of discriminatory trade practices among its members. The MFN principle seeks to avoid discriminatory treatment of member countries of the WTO. As such, any tariff concession extended to one member of the WTO must be extended to all other members. The 'National Treatment' principle requires that all goods, whether imported or not, be treated equally once they have been cleared by Customs.

Article XXIV of the WTO Agreement provides exemption from these principles for member countries to form Regional Trading Agreements (RTAs) so long as such agreements do not increase trade barriers imposed on imports from member WTO countries, and that trade liberalization in such RTAs involves "substantially all trade." On the basis of these provisions, Kenya is a member of both the EAC and COMESA, which are strategic for her industrial development. Kenya also has a preferential trade arrangement with the EU under the EU-ACP cooperation framework presently under the Cotonou Partnership Agreement (previously the Lome Conventions), although only up to 2007. The envisaged Economic Partnership Agreements (EPAs) between the EU and ACP countries are presently being negotiated and must be signed before 31 December 2007.

> Trade agreements, whether bilateral, multilateral or regional, essentially seek to establish rules that enable the participating countries to achieve sustained reciprocal trade liberalization. Such rules restrict the conduct and scope of member countries' trade policies and as a result provide predictability in trade regimes.

Kenya also has bilateral trade agreements with countries and/or markets with which she has strategic trade interests, such as under the General Systems of Preferences (GSP) and the USA African Growth and Opportunity Act (AGOA). These trading arrangements have diverse requirements, which sometimes may be in conflict, therefore creating major challenges in coming up with a general harmonized international trading position.

Kenya in the World Trade Organization

The WTO is mandated to liberalize the global trade environment annd trade and to ensure that international trade is conducted under agreed rules. These agreements include the Agreements on Agriculture (AoA), non-agricultural market access (NAMA), general agreement on trade in services (GATS), and fiber and textiles, among others. These agreements are still a subject of negotiations for further liberalization. Kenya's interest is to ensure that the trading environment is not only free but also fair in the distribution of the benefits of openness to trade.

Within the WTO framework, the latest Round of trade negotiations (the Doha Development Agenda) has sought to put special emphasis on trade as a tool for achieving development. The Doha ministerial declaration presented a wide range of undertakings to accelerate the integration of developing countries into the world trading system through improved trade rules, enhanced market access, and better coordinated trade-related technical cooperation and capacity building. This is because it was felt that the interests of developing countries were not fully taken care of in previous trade negotiations. Further, many of the anticipated gains from previous trade negotiations were not realized by developing countries. Besides, many developing countries found it difficult to implement the various WTO disciplines due to the considerable institutional and economic constraints existing in developing countries.

The proposals during the Doha Development Round were meant to increase participation of developing and least developed countries in trade negotiations and enhance benefits of further trade liberalization. Most of the proposals in the Doha Development Agenda were agreed upon by member states during the 5th WTO Ministerial meeting in Cancun, Mexico in 2003. However, the meeting collapsed because developing and least developed countries felt that most of their concerns were not being taken into consideration. The sixth WTO ministerial meeting will be held in Hong Kong in December 2005 as a follow up to the Cancun meeting and will also focus on the Doha Development Round.

The framework that sets the agenda for negotiations during the Hong Kong meeting in 2005 is what is referred to as the "2004 July Framework Agreement", which was adopted by the WTO General Council meeting on 30 July 2004. The

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main focus of the meeting was to develop a framework for negotiations on agriculture and industrial goods, setting a deadline for services offers, and launching negotiations on a trade facilitation framework. The meeting also re-stated that any agricultural commitments would have to be met by all WTO members and that progress reached in the agricultural sector would have to be matched by advances in other sectors. There is a general commitment by members to complete the Doha Round although there has been a marked lack of political will to push for an ambitious result incorporating other sectors other than agriculture.

The main issues in negotiations for agriculture are a tariff reduction formula, the designation of *sensitive products* (which constitute those tariff lines that all members are permitted to exempt from full formula reductions) and *special products* (a category that allows deviations or exemptions for products essential to food and livelihood security and rural development in developing countries). Sensitive products are those products that countries can protect in the domestic market by controlling imports into their countries using higher tariffs than applies for all other products.

Also for negotiation are issues surrounding the reduction of both production and export subsidies under the pillars of domestic support and export competition. A new issue that has also emerged is the call for a discipline on food aid, which seeks to ensure that food aid is not used as an export subsidy that would lead to commercial displacement.

On non-agricultural market access, the focus is on the formula for reduction of tariffs. Kenya and some eleven other African countries whose tariffs are already less than 35% have been exempted from applying a tariff reduction formula so long as they then (subject to negotiations) bind 100% of their tariff lines at their current levels. Such countries are therefore now preparing to negotiate the coverage of tariffs that will be bound.

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For services, the issue is not on modalities for negotiations but raising the profile and level of ambition of the negotiations.

A major concern within the Doha Round is the development dimension of trade, which seeks to place the needs and interests of developing and least developed countries at the heart of the Doha Work Programme. The issues of concern are enhanced market access, balanced rules, and well targeted, sustainably financed technical assistance and capacity building for economic development in these countries. Of importance here is the negotiations on a pro-development special and differential (S&D) treatment as an integral part of the WTO Agreements. The focus is on review of all S&D provisions within the WTO framework in order to strengthen them and make them more precise, effective and operational.

As an effort to avoid the Cancun "fiasco", member countries have been holding mini-ministerial meetings. Broadly, the meetings, which are invitation-only gatherings of trade ministers, provide a forum for reaching consensus for outstanding negotiation issues among members. However, in practice, 'mini-ministerials" rarely do more than pick up on the dynamics in Geneva (where all technical work on negotiations is undertaken) and agreements reached in these meetings are in no way binding. Proponents of these mini-meetings defend them as being necessary in injecting political momentum into negotiations in Geneva, while critics are wary of the usefulness of deals made in the sittings, which exclude most WTO members.

Following the "July 2004 Framework Agreement" a number of trade mini-ministerial meetings have been held to narrow the gap in various positions put forward by member states to prepare and give impetus and guidance for the Hong Kong meeting. These meetings include: the Ministerial of African Trade Ministers in March 2005 in Mombasa; the 3rd Least Developed Countries Trade Ministers' meeting in Dakar; the Paris Mini-ministerial meeting; the Cairo African Trade Ministers meeting; and the Mauritius ACP and G90 Minister's meeting. These meetings have in general provided the impetus to the negotiations by providing a means of rebalancing issues through guidance on the way forward for negotiations on agriculture, services, non-agricultural products, anti-dumping and other related trade issues. In particular, the meetings have given a political push to consensus on issues to be negotiated by the Geneva-based technical committees.

Kenya in the EAC and COMESA

The underlying logic behind the push towards regionalism in Africa is basically sound for the following reasons. First, regional integration schemes permit the creation of larger markets from the small uneconomical and segmented markets found in individual African

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countries. Second, regional integration schemes foster competition and as such positively benefit consumers. Third, regional integration schemes increase the bargaining power of the continent in international trade negotiations and in other multilateral fora. Fourth, regional integration schemes permit policy makers to "lock in" their policies, and therefore make them more predictable in addition to safeguarding them against adverse domestic pressure. Fifth, regional integration schemes may help fulfill certain political and social objectives, including: helping to reduce hostilities in the region, and enhancing regional specialization in a number of economic and social spheres.

Although many attempts at integration in the region have floundered, regional integration schemes in East Africa predate the First World War. The most recent attempt at regional integration in East Africa begun with the resumption of formal ties between the three EAC countries in July 1993, through the formation of the Permanent Tripartite Commission for Cooperation. The EAC Secretariat was launched in 1996 and with it the commencement of operations of the EAC. The EAC Treaty, which was signed in 1999 and officially launched in January 2001, provides for a progressive regional integration process beginning with a Customs Union, followed by a Common Market, then a Monetary Union and ultimately a Political Federation. The Customs Union Protocol was signed in February 2004 and formally begun operations in January 2005. The principle of asymmetry will govern trade within the Customs Union in the first five years of operation. Essentially, this means that while Ugandan and Tanzanian exports to Kenya and to each other will be free of duty, Kenyan exports to Tanzania and Uganda will still attract some duty-on a declining scale, although at a preferential rate. This has been implemented to allay fears that Kenya would, once more, disproportionately benefit from the trade bloc fears, which resulted in the collapse of previous attempts at integration.

The next hurdle for the EAC members is the implementation of the Customs Union band and movement into deeper forms of integration.

The integration process known as the Common Market for Eastern and Southern Africa (COMESA) began with the signing of the treaty for the Preferential Trade Area for Eastern and Southern Africa (PTA) in December 1981. Twenty-one countries in the Eastern and Southern Africa region (with a population of about 300 million people and a combined GDP of US$ 200 billion) signed a treaty in November 1993 formally establishing COMESA as a successor to the PTA. This was part of the Lagos Plan of Action, which sought to provide a conceptual framework for economic integration in Africa. According to the Plan, regional integration schemes in Africa were to serve as building blocs for the envisaged Economic Community for Africa. The PTA led to a system of preferential tariff reductions on distinct products, which has subsequently led to an expansion of intra-community trade.

> Regional integration schemes permit the creation of larger markets from the small uneconomical and segmented markets found in individual African countries; foster competition and as such positively benefit consumers; increase the bargaining power of the continent in international trade negotiations and in other multilateral fora; permit policymakers to lock in their policies, and therefore make them more predictable in addition to safeguarding them against adverse domestic pressure; and may help fulfill certain political and social objectives

The main objective of the COMESA treaty is to promote cooperation and development in all fields of customs, industry, transport, communication, agriculture, natural resources and monetary affairs aimed at promoting the living standards of the region. However, the most vital activities remain trade liberalization and economic integration. The medium term plans for liberalization within COMESA include the eventual elimination of all tariff barriers between member states and the establishment of a Common External Tariff (CET) with the onset of a Customs Union *circa* 2008.

Although the main goal of COMESA was to increase cooperation in all areas of social and economic activity, enabled by a single market, the broad goals of the trading bloc are much wider and include priorities such as promotion of peace and security in the region. The entire COMESA mandate can only be fulfilled in the long term. In the medium term, the COMESA mandate and priorities are defined as being integration through trade and investment in an outward oriented framework.

Kenya's dual strategy of negotiated regional and international trade liberalization for securing market access seeks to maximize on the gains from export trade with neighboring (relatively unindustrialized) countries. Judging from the flow of Kenya's manufactured exports to the region, this strategy has been relatively successful. In addition to lowering trade barriers, these initiatives have also permitted institutional, infrastructure and other behind the border reforms that are pertinent for Kenya's smoother integration into the global economy. Through regional integration

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initiatives, Kenyan firms are able to build key competencies in the regional markets before attempting to export to the more competitive international markets.

Kenya's trade with the EAC dominates trade with any other region, although trade with COMESA is growing faster. There is a growing trend of Kenyan exports to the region, perhaps facilitated by the country's superior geographical location and relatively more industrialized economy within the region. Kenya's captive market in the region is therefore mainly for manufactured consumer goods.

Regional markets serve as a natural destination for exports of Kenyan manufactured goods. However, the low incomes of the regional economies cannot guarantee the type of growth in demand that would sustain industrial expansion in Kenya and propel the country to the level of an industrialized nation. The ultimate goal must therefore be to supply developed country markets, which requires the country to develop a more aggressive industrial transformation strategy that embraces building technological capabilities as one of its central planks.

The more immediate pressing problem for Kenya within the EAC and COMESA framework is the need to rationalize the country's participation in different trading arrangements in the region. As of now, the country is already a member of the EAC Customs Union and is a member of COMESA, which envisages to become a Customs Union by 2008. Once this happens, Kenya will have to make a critical choice between keeping her trade arrangements in conformity with the provisions of the WTO. It is not possible for WTO members to belong to more than one Customs Union. As such, Kenya will either have to withdraw from EAC or COMESA or join COMESA (and any other trade body) under the auspices of the EAC. A quick solution is to fast track EAC integration so that EAC members would negotiate with other bodies - COMESA and SADC- as a unit. Meanwhile, the present trade negotiations will have to be pursued in such a way that the outcomes do not result in a disruption of the flow of goods and services within the region. Already, there are several moves to have the trade regimes in COMESA and EAC converge. For example, the adoption of the "COMESA Rules of Origin" by the EAC has permitted trade to flow between the countries without disruption.

Kenya in the EU-Eastern and Southern Africa (ESA) EPA

The expected changes in the trade arrangements between Kenya and the EU have provided the country with an opportunity to evaluate the overall trade policy agenda. Previous trade arrangements as embodied in the expired Lome Convention trade arrangements focused on the EU extended non-reciprocal trade preferences to Kenya. The successor trade agreement, Cotonou Partnership Arrangement (CPA), was only able to extend the non-reciprocal trade arrangement up to end of 2007, after which such arrangements will have to conform to the WTO provisions. The Economic Partnership Agreements (EPAs) being negotiated between the EU and ACP countries are aimed at achieving this.

An EPA, as envisaged in the CPA, would be some form of a free trade area conforming to the provisions of Article XXIV of the WTO. The EU prefers that negotiations be held within the framework of existing African regional trade arrangements. However, given the multiple regional trade arrangements in Africa it was incumbent upon African countries to rationalize their participation in existing RTAs. Kenya's choice of the sixteen Eastern and Southern African (ESA) countries' configuration to negotiate an EPA with the EU was dictated by the need to be sensitive to her obligations and those of other EAC member countries to existing RTAs. Kenya's position would, therefore, first of all have to be negotiated with ESA countries after which the joint ESA position would need to be negotiated with the EU. The EPAs that emerge from these negotiations would be signed between the EU and individual ESA countries. The sixteen countries in the ESA configuration are Burundi, Comoros, Congo DRC, Djibouti, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius,

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Rwanda, Seychelles, Sudan, Uganda, Zambia, and Zimbabwe.

Kenya is the dominant economy in the ESA region in respect of its substantial trade within the ESA configuration. It would be in her strategic interest to defend, even after the formation of an EPA, the export advantage she maintains in the region for certain manufactured goods. As such, the leading role that Kenya is playing in the ESA-EU negotiations is probably informed by the need to protect the market for exported manufactured goods. This is because EPAs present a challenge of imports competing with the manufacturing sector for the domestic market and in the ESA export market.

cheaper, and possibly higher quality, imports will improve consumer welfare as a result of trade creation (which might occur when inefficient domestic suppliers are replaced by more efficient EU exporters of the same goods). This result, however, must take into account the possible loss of jobs, which will reduce the consumer welfare gains. Further, it is noted that EPAs may also result in trade diversion (which might occur when EU suppliers displace more efficient suppliers from the rest of the world) because of the reduction in tariffs. This may even jeopardize intra African trade and by so doing compromise the regional integration efforts being undertaken in the continent.

Existing studies by the United Nations Commission on Africa (UNECA) regarding the implications of a EU-ESA EPA for African economies show that African countries involved in EPAs would face significant revenue loses and huge adjustment costs. Further, it is anticipated that the EPAs may exacerbate de–industrialization in the African countries, with diverse effects on the agricultural sector for most African countries and specifically for the cereals and dairy products, which are highly subsidized in the EU. However, the

Despite the above observations, trade simulation results that have been undertaken by the united Nations Economic Council for Africa (UNECA) show that trade creation effects of the EU-ESA EPAs will be significant and in favor of the EU, therefore leading to the conclusion that EPAs will lead to trade expansion. The simulations show, for example, that Kenya, Mauritius, Sudan and Ethiopia will benefit most from the trade creation effects. In the case of Kenya, this will be to the tune of US$ 211 million. The EPA will also have significant revenue loss implications for Kenya to the tune of US$ 107 million. There may also be huge adjustment costs incurred to replace this revenue in the short term.

The EU-ESA EPA phase II negotiating guidelines state that the primary objective of EPAs should be the sustainable development of the ESA countries. *Ex-ante* studies show that careful cost benefit analysis should be undertaken before the EPAs are signed. However, the EU holds the key to the success of these trade negotiations. For many of the ACP countries considered least developed and therefore already benefiting from the Everything But Arms (EBA) initiative, an important benefit from forming an EPA with the EU would be the possibility of benefiting from additional financial resources ostensibly for addressing the supply-side constraints. Initial remarks by the EU, however, indicate that additional resources over and above those already committed under previous agreements with ACP countries may not be forthcoming. In the event that this should happen, the EBA countries in the ESA configuration would possibly pull out of the EU-ESA EPA negotiations, leaving behind only the three or so countries—Kenya, Mauritius and Zimbabwe—which are considered developing countries. Kenya would be further isolated as the other two already benefit from other EU concessions on account of being island and landlocked states, respectively. The crucial challenge for Kenya is therefore to prepare for such an eventuality. Considering the foregoing, Kenya may need to consider negotiating by itself a separate trade arrangement with the EU, as a fall back, without relying on her regional trading partners.

In conclusion, many more studies that should inform these decisions are being undertaken in Kenya, including in KIPPRA. Overall, Kenya seems to be better prepared in the trade negotiations than other ESA countries. ❑

Kenya's economic recovery is expected to maintain the momentum gathered since 2003. The actual real GDP growth rates have so far almost marched the projected growth rates in the Economic Recovery Strategy (ERS) for Wealth and Employment Creation. The economic recovery that started in 2003 deepened in 2004 as real economic growth reached 4.3%. The high growth in 2004 resulted from high exports performance, rapid growth in investments and expansion in private consumption caused by increased lending by commercial banks. In real terms, exports of goods and services grew by 19.8%, investments by 8.1% and private consumption by 1.9% in 2004. This was supported by favourable supply conditions that saw tourism and related services grow by 15.1%, and transport and communication by 9.7%. Trade registered a real growth of 9.5% while growth in manufacturing and construction sectors was also high. Growth is currently projected to consolidate at around 5% over 2005-2006, mainly driven by rising investments both in the public and private sectors and also by increased exports.

Private sector investment

The ongoing efforts to create a favourable investment climate through a stable macroeconomic environment and the reconstruction efforts under the public infrastructure development programmes are expected to continue bearing fruits for private sector development. Therefore, private investment is expected to continue picking pace in 2005 as the economic recovery takes hold. Stable interest rates, coupled with prudent fiscal policy, are expected to underpin the recovery witnessed in the last two years in the business investments.

Regional markets

The widening of the regional market through COMESA and the East African Community is also expected to play a big part in translating investment plans into actual projects to cater for the expanding regional market. The regional economies are expected to continue growing strongly, and a similar strong growth is expected in the rest of the non-COMESA sub-Saharan Africa economies that have become an important destination of Kenya's exports. Private investments are projected to rise by an average of 7.7% over the years 2005 and 2006 due to the improving domestic and regional conditions.

Tourism

The security situation in Kenya is expected to improve as the Government's efforts in this sector start to bear fruit, translating into higher tourism receipts. So far, compared to a similar period last year, tourist arrivals are higher than in 2004. The arrivals in January-May 2005 have increased by 31% compared to the same period last year and are expected to remain at these levels in the remaining half of the year. The efforts to transform the Jomo Kenyatta International Airport into an air transport hub through refurbishment of the airport's facilities; the opening up of new routes to South East Asia; and the resumption of flights into Nairobi by major airlines is expected to support the recovery in the tourism sector.

Coffee, tea and horticultural exports

Whereas the volumes of coffee sold to the international markets have declined by 2% in the first half of 2005, coffee continues to enjoy better prices resulting in better earnings. The high coffee prices are expected to be maintained in the remaining half of 2005. The volume of tea sold to the international markets has risen by 7% in the first half of 2005, although tea prices in the international market have declined over the first half of 2005, resulting in low earnings from the commodity. Trade in horticulture also follows the patterns witnessed with coffee. The volumes sold in the international markets declined in the first half of 2005, but the resulting better prices have generated better export earnings. All these are expected to support growth in total exports, which are projected to grow at an average rate of 5.3% over 2005/6.

Construction industry

An additional supply factor likely to influence the ultimate growth outcome in 2005 is the high growth in the construction sector. The growth within the construction sector is best manifested in the improved performance of the two key cement manufacturing firms, Bamburi and Portland, which have posted high profits and increased sales in the first half of this year. There are marked improvements in cement consumption over the last half of the year compared to the same period last year. Overall, cement consumption has risen by about 7.5% in the first half of 2005, and is expected to remain high throughout the year.

Macroeconomic stability

In spite of a challenging international environment occasioned by inflation in commodity prices, macroeconomic stability is being sustained. The exchange rate of the Kenya shilling to major currencies and interest rates have remained

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stable, therefore supporting the economic recovery process. The shilling witnessed a depreciation of only 4.4% from 2003 to 2004. The shilling is expected to remain relatively stable with a marginal depreciation in the medium term following the slight nominal appreciation so far being experienced in the best part of 2005. As for inflation, at the international arena, the high commodity prices that prevailed over 2004 are expected to prevail in 2005. With the global economy expected to continue growing strongly, the rising prices in the commodities markets and high oil prices coupled with a weak shilling will feed into the Kenyan inflation, which averaged 11.7% in 2004. Since international prices are expected to remain high, Kenya's overall inflation is also expected to be high in 2005 and expected to settle at 10.8%. Nonetheless, overall inflation is expected to decline from the annual average of 11.7% in 2004 to 6.4% in 2006.

Contrary to the conventional wisdom regarding donor aid, the policy shift by the Government of excluding non-committed budget support in the budget will help create certainty in the money markets. The uncertainty that has tended to accompany announcements by major donor countries on whether or not they will release resources factored in the budget will be minimal as the markets expectations that are likely to affect interest rates negatively will now depend mainly on the performance of the Kenya Revenue Authority (KRA) and the prudence and efficiency of Government spending. If the Government spending plans remain as given in the budget and the tax administration reforms that KRA is implementing remain on course, then the short-term interest rates, which have a bearing on the Government's interest expenditure, are likely to remain stable around 8.4% over 2005-2006. Consequently, the average base-lending rate of 12-15% with an average premium of 3-4 percentage points is likely to prevail over the period 2005-2006.

	2004	*2005*	*2006*
Real GDP growth	4.3	4.8	5.1
• Investments	8.1	4.6	10.4
• Exports	19.8	5.7	5.0
Inflation (CPI overall) (%)	11.7	10.8	6.4
Short term interest rate (Tbill)	3.6	8.5	8.3
Exchange rate (Ksh/$)	79.3	77.8	79.0

Source: KIPPRA Treasury Macro Model (KTMM)

Fiscal policy

Besides macroeconomic stability, an aggressive fiscal restructuring by the government over the last fiscal years has also supported economic recovery. While overall expenditure to GDP rose from 23.6-25.9% in 2003/04 and 2004/05, respectively, the bulk of the increases in expenditure were channeled to development. Consequently, the share of development expenditure increased from 2.7-4.7%, while recurrent expenditure stagnated at around 21%. This expenditure restructuring is expected to continue in the medium term. While overall expenditures are expected to stabilize at around 27.6% of GDP, development expenditures are expected to increase, reaching an average of 6.5% of GDP in 2006/7 as the government earmarks more resources to infrastructure development. Even though recurrent expenditures are expected to decline marginally over the same period, government expenditures in the provision of social services are expected to increase as more resources are allocated to areas directly supportive to meeting poverty reduction targets and the overall targets of the Millenium Development Goals (MDGs).

On the other hand, while revenues are expected to stagnate at around 21% of GDP, grants are expected to rise to 2.3% by 2006/7. Given the expected expenditure profile, a widening deficit will result. The deficit, given the current fiscal policy stance will be financed primarily from domestic borrowing with net domestic financing averaging 2.6% of GDP by 2006/07.

Fiscal framework (% of GDP)

	2003/04	2004/5	2005/6	2006/7
Expenditures	23.6	25.9	26.8	27.6
Recurrent	20.9	21.2	20.8	21.0
Development	2.7	4.7	5.9	6.5
Revenues	21.8	22.8	22.0	22.0
Grants	1.4	1.6	1.6	2.3
Overall balance (cash basis)	0.2	-1.2	-3.4	-3.5
Financing	-0.2	1.2	3.4	3.5
Net foreign	-0.8	-0.2	1.5	1.5
Net domestic	0.5	1.4	1.8	1.9

Source: Medium Term Budget Strategy Paper, 2005/06 – 2007/08

One of the core mandates of the Institute is to provide capacity building for public policy making. There are now several regular capacity building programmes, including secondment of public officers to the Institute for on-job training, the KIPPRA Young Professionals Programme (KYPP), and specific formal courses organized from time to time. Moreover, the Institute participates in policy working groups and task forces, discussion roundtables, workshops, and conferences.

Government and private sector officials during the launch of the survey on security risk and private sector growth

Overview of capacity building programmes

The process of formalizing the KYPP continued. The class of 2004 graduated and returned to their jobs, having gained considerable capacity. The 2005 class has commenced training. The Programme is aimed primarily at the public sector and is expected to improve the process of policy analysis, formulation, implementation and monitoring and evaluation.

At least half of the trainees admitted every year must be economists with Masters degree and working in the public sector, although similarly qualified economists from the private sector are also eligible. The positions are advertised in the press every year and participants selected on a competitive basis. The programme runs for one year.

Meanwhile, several KIPPRA staff have continued with their doctoral studies. Moses Sichei is about to complete his training in econometrics in South Africa, while Jane Kiringai is proceeding with her training in macroeconomics in the UK. Maureen Were is about midway in her macroeconomic studies in Tanzania, and Lydia Ndirangu is also midway with her research in the Netherlands.

Capacity building for MSEs

The micro and small enterprise (MSE) sector is a major contributor to employment and livelihood in Kenya. Despite progress in the tolerance and friendliness of policies towards the sector, especially since the late 1980s, there have been considerable bottlenecks with respect to implementation of policies, largely due to capacity constraints. KIPPRA has started a comprehensive *Core Capacity Building Programme* to train public sector officials involved in the policy process for the sector. To date, five training modules have been

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Three economists and three mathematicians were going for a trip by train. Before the journey, the mathematicians bought three tickets but economists only bought one. The mathematicians were glad their stupid colleagues were going to pay a fine. However, when the conductor was approaching their compartment, all three economists went to the nearest toilet. The conductor, noticing that somebody was in the toilet, knocked on the door. In reply he saw a hand with one ticket. He checked it and the economists saved 2/3 of the ticket price. The next day, the mathematicians decided to use the same strategy- they bought only one ticket, but economists did not buy tickets at all! When the mathematicians saw the conductor, they hid in the toilet, and when they heard knocking they handed in the ticket. They did not get it back. Why? The economists took it and went to the other toilet.

And finally, did you know that...

Economic forecasters assume everything, except responsibility developed and a core group of people trained as trainers.

The main objective of the programme is to build capacity for for policy analysts, implementers and managers to understand, interpret, formulate and articulate MSE policy issues. The skills enable them to engage in policy dialogue with development practitioners and partners. Ultimately, the aim is to increase the level of adoption of policy recommendations and therefore narrow the gap between MSE policy formulation and implementation. The programme covers five modules, namely: Guidelines on policy analysis and formulation; Micro and small enterprise development; Research methodology and communication; Micro and small enterprise programme management; and Monitoring and evaluation for micro and small enterprise policies.

The programme is organized into modules to allow for flexibility. Participants are awarded certificates on successful completion of minimum four modules, three of which are compulsory. A total of 27 trainers of trainers have covered all the five modules required to complete the Core Capacity Building Programme. These will graduate in August 2005.

New plans

Besides the ongoing capacity building programmes, the Institute has developed a concept note for a senior fellowship programme aimed at senior policy makers and implementers. The aim is to attract senior government officers to the Institute for a short period for hands-on policy analysis and research while sharing with staff at the Institute. On account of their experience, moreover, the senior fellows could also have a major impact on the Institute's researchers. The target group will be consulted to assess their capacity building needs and availability before the programme design is completed.

Tax Cuts Explained

Let's put tax cuts in terms everyone can understand.

Suppose that every day, ten men go out for dinner.

The bill for all ten comes to £100.

If they paid their bill the way we pay our taxes, it would go something like this:

- *The first four men (the poorest) would pay nothing.*
- *The fifth would pay £1.*
- *The sixth would pay £3.*
- *The seventh £7.*
- *The eighth £12.*
- *The ninth £18.*
- *The tenth man (the wealthiest) would pay £59.*

So, that's what they decided to do.

The ten men ate dinner in the restaurant every day and seemed quite happy with the arrangement, until one day, the owner threw them a curve.

"Since you are all such good customers," he said, "I'm going to reduce the cost of your daily meal by £20." (Equivalent/analogy to a tax reduction)

So, now dinner for the ten only cost £80. The group still wanted to pay their bill the way we pay our taxes, with the poorest paying little to nothing and the wealthiest, the most. So, the first four men were unaffected. They would still eat for free. But what about the other six, the paying customers? How could they divvy up the £20 windfall so that everyone would get his "fair share"?

The six men realised that £20 divided by six is £3.33. But if they subtracted that from everybody's share then the fifth man and the sixth man would each end up being 'PAID' to eat their meal. So, the restaurant owner suggested that it would be fair to reduce each man's bill by roughly the same amount, and he proceeded to work out the amounts each should pay. And so:

- *The fifth man, like the first four, now paid nothing (100% savings).*
- *The sixth now paid £2 instead of £3 (33% savings).*
- *The seventh now paid £5 instead of £7 (28% savings).*
- *The eighth now paid £9 instead of £12 (25% savings).*
- *The ninth now paid £14 instead of £18 (22% savings).*
- *The tenth now paid £49 instead of £59 (16% savings).*

Each of the six was better off than before. And the first four continued to eat for free. But once outside the restaurant, the men began to compare their savings.

"I only got a dollar out of the £20," declared the sixth man. He pointed to the tenth man (the "wealthy" one) "but he got £10!"

"Yeah, that's right, "exclaimed the fifth man. "I only saved a dollar, too. It's unfair that he got ten times more than me!"

"That's true!!" shouted the seventh man. "Why should he get £10 back when I got only £2? The wealthy get all the breaks!" (Sounds familiar?)

"Wait a minute," yelled the first four men in unison. "We didn't get anything at all. The system exploits the poor!" (Sounds familiar?).

So the nine men surrounded the tenth and beat him up.

The next night the tenth man didn't show up for dinner, so the nine sat down and ate without him. But when it came time to pay the bill, they discovered something important. They didn't have enough money between all of them for even half of the bill!

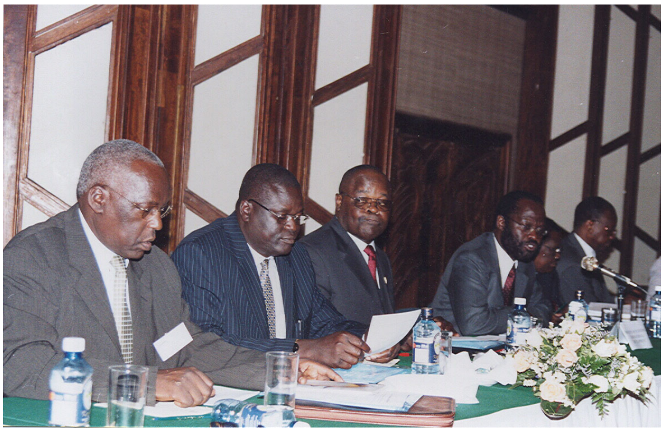
And that, boys and girls, journalists and college professors, is how our tax system works. The people who pay the highest taxes get the most benefit from a tax reduction. Tax them too much, attack them for being wealthy, and they just may not show up at the table anymore.

Regional Macromodelling training workshop

The regional training on macroeconomic modeling was supported by the African Capacity Building Foundation (ACBF) and the IMF-AFRITAC East. The training attracted participants from 12 countries from Eastern and Southern African region and focused on training participants on how to build and use macro models in policy analysis and simulations. The training was held from 25 April-6 May, 2005 at the Kenya School of Monetary Studies, Nairobi.

Improving the Enabling Environment for Busines in Kenya

The Institute organized a very successful conference on improving the enabling environment for business in Kenya. The conference was held on 20 January 2005 and opened by His Excellency Hon. Dr Moody Awori, EGH, EBS, MP, Vice President of the Republic of Kenya and Minister for Home Affairs. The conference was also attended by Hon. Prof. Peter Anyang' Nyong'o, Minister for Planning and National Development, and also a number of Permanent Secretaries.

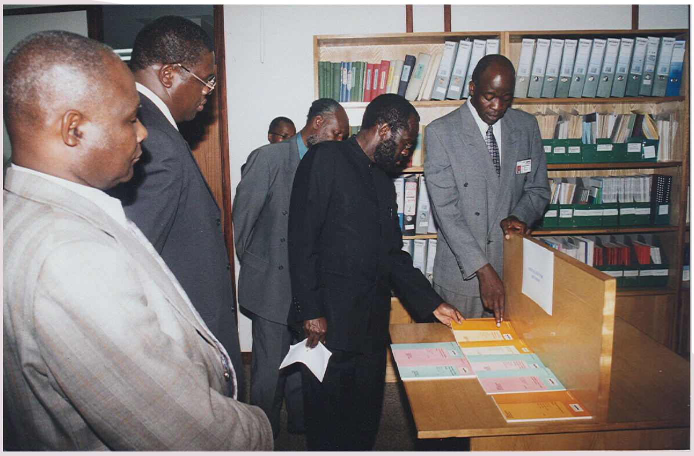


Urban and regional planning as an instrument for wealth and employment creation

The Conference was held in February as a culmination of studies aimed at understanding causes of Kenya's poor urban and regional planning and recommending remedial policy shifts. Among important proposals developed on the way forward were the need for a strong but realistic vision for urban and regional planning; effective policies, laws and institutions; and a well-coordinated planning practice.

Financial sector in the economic recovery process

The Institute organized a one-day workshop on 4 March 2005 bringing together various players in the financial sector. The theme of the workshop was "Financial sector in the economic recovery process: Role, challenges and future." The Kenya Private Sector Alliance, and the Parliamentary Committee on Finance were among the participants at the workshop.



Minister for Planning and National Development, Hon. Prof. Peter Anyang' Nyong'o (EGH, MP) during a familiarization tour of the Kenya Institute for Public Policy Research and Analysis, KIPPRA, in January 2005

KIPPRA Management staff and Board Members during a retreat at the Naivasha Simba Lodge in March 2005 to discuss corporate governance and the requirements of performance contracts.

Capacity building in the MSE sector

The Institute continued building capacity for policy analysts and implementers in the Micro and Small Enterprises (MSE) sector. So far a total of 27 people have been trained. The other component of the project, entailing assessment of the capacity of MSEs associations, has also commenced and a draft needs assessment report has already been prepared.

Urban public transport patterns in Kenya

Urban public transport in Kenya presents significant challenges especially in Nairobi. Public transport in Nairobi is characterised by a huge demand gap, high fares, high road traffic accident rates, captive travelling, and suffocating vehicular pollution, all operating against a hazy urban transport policy backdrop. KIPPRA has conducted a survey on transport demand for Nairobi with the aim of formulating a suitable model for current and future transport. The survey started with a breakfast meeting for various stakeholders, and the findings of the study were disseminated during a stakeholders conference.

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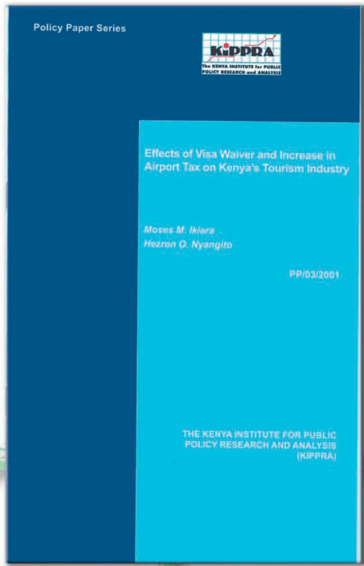
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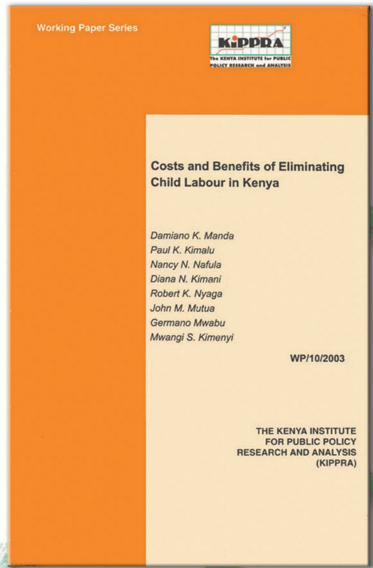
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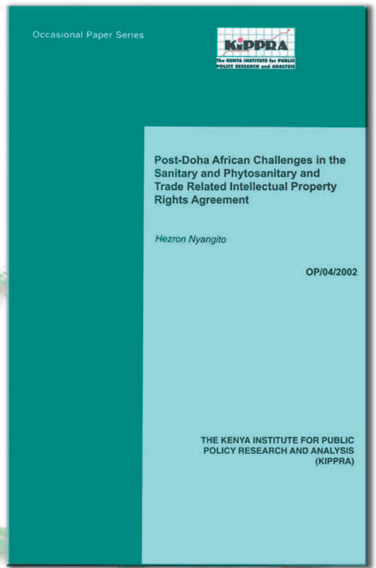
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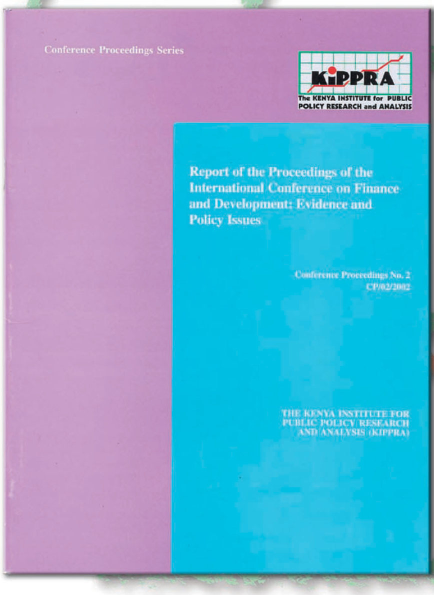
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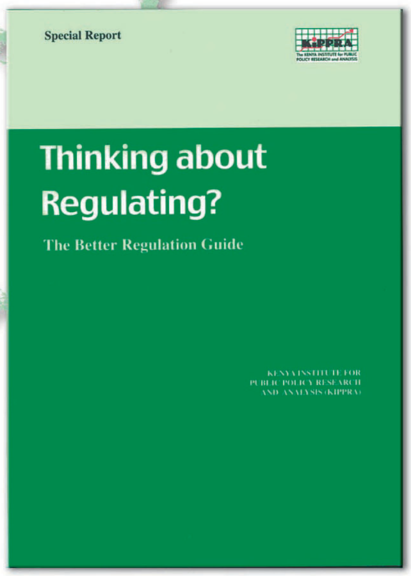
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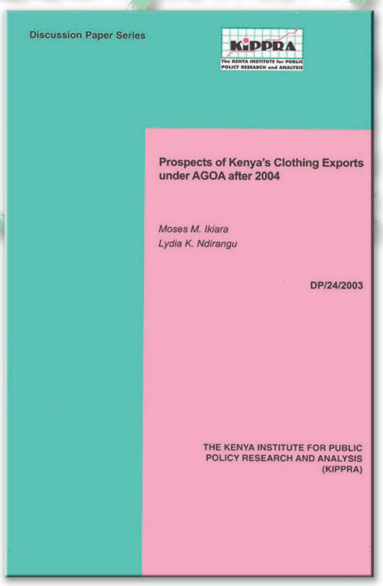
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