

Role of Trade Policy and Trade Reforms in Poverty Reduction in Kenya

Introduction

Kenya's economic development strategy has often used trade policy as part of an assortment of policies towards achieving economic growth and poverty reduction. More recent trade liberalization efforts have aimed at improving resource allocation, which in turn would lead to growth and therefore to poverty reduction. However, the Kenyan economy has stagnated for some time now. To address the poor performance of the economy, the Government came up with the Economic Recovery Strategy (ERS) for 2003-2007. However, this strategy does not provide a clear link between trade policy, growth and poverty reduction. The strategy sees trade policy as a way of gaining market access in regional and international markets. Implicitly, increased market access will lead to greater exports and therefore growth, with poverty reduction occurring as a natural consequence. However, what is overlooked is that concessions have to be made domestically in order to gain export market access. This may have consequences for economic growth and poverty reduction in Kenya.

This policy brief aims to demonstrate that the linkage between trade and poverty may not be one way and more needs to be done to ensure that poverty reduction occurs from increased trade opportunities. The brief is based on a study: *The role of trade policy and trade reforms in poverty reduction: Some Kenyan perspectives*. The study highlights the implications of Kenya's trade policy for economic growth and poverty reduction and identifies supporting policies.

Major Findings

The main findings of the study are organized around five issues:

1) *Are there theoretical links between trade and poverty?*

A review of literature shows numerous channels through which trade liberalization results in growth and increased average incomes. These channels include the *investment channel*, through which there is increased efficiency in investment as most capital goods are imported; and *reduced rent seeking activities*, and therefore greater incentives for innovation and entrepreneurship.

Trade policy may affect the poor through the prices of goods and services consumed by the poor, and which affect their real incomes; and through the performance of firms, with implications for wages and employment. Trade liberalization results in poverty reduction when it leads to an increase in availability of low-skilled employment, tighter labour markets and an increase in the relative wages of low-income workers. Further, if trade liberalization enhances government revenues it would enable additional pro-poor spending.

2) *Outcomes of trade policy episodes in Kenya*

Trade policy in Kenya has evolved through two distinct periods: the imports substitution phase from independence to mid 1980s, and the period of trade

reforms from 1980s to date. The objectives of the import substitution industrialization policy were to achieve rapid growth of industry and increased local control of the domestic economy. Restrictive trade policy to protect the domestic industry was one of the instruments used to achieve these objectives. This policy proved costly because it increased the overall cost structure, which harmed exports relative to the protected imports substituting activities, therefore resulting in resource misallocation. A highly dispersed tariff structure also emerged, which tended to result in resource misallocation.

Trade liberalization, which begun in the mid 1980s has led to positive results at the sector level. In the agricultural sector, for example, the reform measures resulted in stabilization of both the consumer and producer prices of maize and a fall in maize price differentials between Kenya and its partners, as private millers entered the sector. Liberalization in the dairy sub-sector has led to increased prices for both small and large producers of milk. In the industrial sector, liberalization has resulted in dismantling of the tariff and non-tariff barriers that protected import-competing products. The negative effects of these reforms on manufacturing jobs have been mitigated by the provision of various incentive schemes such as manufacturing under bond, import and duty remission scheme and export processing zones. The aim of these schemes was to induce industries to export.

3) Trade policy content of Kenya's development strategies

Initially, trade policy in Kenya was used to provide industrial protection and therefore assist with the structural transformation of the economy. Trade liberalization has more recently become part and parcel of a pro-poor pro-growth development strategy. Recent poverty reduction plans have given emphasis to growth and trade as important means of achieving poverty reduction. However, the Poverty Reduction Strategy Paper (PRSP) did not explicitly dwell on trade as a strategy for poverty reduction. Other than emphasizing the need to gain market access for Kenyan exports to regional and international markets, the Economic Recovery Strategy 2003-2007 also does not explicitly address the issues of trade and poverty especially with regard to improved livelihoods. Kenya's position

papers to the World Trade Organization (WTO) have however expressed concern on how different trade practices may affect the poor.

4) Trade and poverty in Kenya: Macro perspectives

Although trade liberalization has led to increased exports and imports since it begun intensively in the mid 1990s, it has also had mixed outcomes. For example, the rate of growth of imports has increased and surpassed that of exports. It has also had positive effects on the agricultural sector at the macro level, while leading to a fall in manufacturing output due to competition from imports. Trade liberalization has also contributed to a fall in employment in all sectors with the most affected workers being unskilled and semi-skilled workers.

5) Trade and poverty in Kenya: Sectoral perspectives

A number of studies have also looked at the trade-poverty linkages from a sectoral perspective. The case studies selected include sugar, cotton, horticulture and fisheries sub-sectors. These sub-sectors are dominated by small scale producers.

a) Sugar sector

Kenya is currently an uncompetitive producer of sugar in the world and local production can only occur under heavy protection. Absence of protection would generally lead to high incidence of poverty among the mainly small scale sugarcane producers. Sugarcane cultivation, however, displaces production of food for own consumption and food insecurity is therefore high among small scale sugarcane growers.

The sugar sector is constrained by inefficient factories, which result from under-investment in processing capacity. Delays in payments to farmers have led to neglect of cane production. The other challenges facing the sector include: mill level inefficiencies and management failures; pan territorial pricing (single price across different locations); debt and insolvency; high taxes; and farm level problems. This sector can play a bigger role in promoting growth and poverty

reduction if the government implemented the report of the 2003 *Amayo Task Force on the Sugar Sector in Kenya*. As a last resort, there should also be adequate sensitization and support to sugar cane farmers to enable them diversify into other profitable cash crops that can do well in their agro-climatic zones.

b) *Horticultural sector*

Kenya holds a significant market share in floriculture, fruits and vegetable exports to the European Union. Employing almost 3 million people, the sector has a significant impact on both rural and urban poverty. The sector contributes up to 30-35% export revenues and also contributes significantly to household income. Around 80% of all growers are small holders who produce 70% of the sector's output and 60% of exports. Further, semi-skilled workers are also heavily involved in pre-export processing and packing. However, the introduction by the EU of conditions and standards such as traceability, maximum residue levels, quarantine, packaging, recycling requirements, and human welfare and safety standards, among others for non-EU suppliers has increased transaction costs for small holders, giving advantage to large-scale producers who enjoy economies of scale and therefore have lower costs. In response to increased demands from importers, the government has developed a harmonized industry code of practice to forestall individual failures that would expose the entire industry to a blanket ban.

The potential loss of preferential access to the EU market may lead to a loss of market share and to declining profitability, resulting in a departure of investors from the sector. Finally, poor domestic infrastructure has resulted in losses for both farmers and exporters, while high airfreight costs make up a substantial proportion (50-75%) of exporters costs.

To improve the sector's performance and contribution to growth and poverty alleviation, the crucial issues of infrastructure and airfreight costs need to be addressed to mitigate the additional costs of meeting the stringent requirements in the EU. The government's negotiating position should, in addition to safeguarding Kenya's market access to the EU on reasonable terms, seek to secure additional support from the EU to set up

equipment and laboratories required to meet these new requirements.

c) *Fisheries sector*

More than 500,000 Kenyans are employed directly or indirectly in the fisheries sector while more than 800,000 others depend on fisheries for their livelihoods. More employment opportunities are generated in processing, packaging, boat building and net making as a direct result of the export markets. About 93% of fish harvested in Kenya is from Lake Victoria. Over 30% of this is exported and 70% of the exports go to the EU. Kenyan exporters of fish have been vulnerable to the various export bans on fish going to the EU, resulting in a significant decline in fish exports to that market.

To address the critical challenges that face the sector, and in order to boost its contribution to growth and poverty alleviation, the government should improve the hygiene, sanitation and general health conditions of fish production and processing. The government should also improve infrastructure at the landing sites, and invest in improvement of identification and traceability to guarantee continued access to the EU market.

d) *Cotton sector*

The cotton sector has been a beneficiary and also a victim of globalization and liberalization. The implications for poverty in the cotton growing areas of Kenya have been immense as cotton is mainly grown by small holders. About 140,000 farmers grow cotton under rain-fed conditions mainly in the arid and semi arid regions of Nyanza, Coast, Eastern and Rift Valley provinces where there are large concentrations of poverty. There is also a large potential of absorbing large numbers of unskilled and semi-skilled workers in the processing and manufacturing of cotton. The number is even higher when those involved in ginning, spinning units, textile mills and clothing manufacture are considered.

Although it has dropped in terms of its employment capacity, the cotton-textile industry is a significant employer. The performance of the sector has dwindled since trade liberalization in the early 1990s due to adverse import competition, among other factors.

To increase the sectors contribution to growth and poverty alleviation, policy should seek to promote the productivity of the sector right from farm level to the factories. The government should intensify extension services to farmers and promote investment in ginneries and spinning units, either by granting investment incentives or through tax rebates. The government should also pursue policies that will ensure that input costs for cotton are reduced, probably by reducing import duties on imported inputs.

Conclusions and Recommendations

There are clear channels through which trade policy affects the poor. Policy makers should try to understand these channels and ensure that the positive effects of trade liberalization trickle down to the poor while mitigating the negative effects through targeted government interventions.

Import substitution and trade liberalization phases of trade policy in Kenya have had mixed effects on the economy. In order to guarantee continued support for trade reforms, the Government should try to mitigate the losses incurred from trade liberalization and especially those faced by the poor.

At the macro level, manufacturing has borne the brunt of the negative impacts of trade reforms while the effect on agriculture has mainly been positive. The Government should provide additional incentives to the manufacturing sector to ensure that it becomes more competitive.

Trade liberalization has impacted negatively on the sugar sector, as the sector has been inundated with

competition from cheap imports. The Government should concentrate on making the sugar sector more competitive so that its contribution to poverty alleviation can be safeguarded.

There is need to also safeguard the huge employment potential of the horticultural sector by providing adequate and cheap infrastructure and by ensuring that the preferences in the EU market are preserved on reasonable terms.

Because of the huge employment and poverty reduction potential of fisheries, the government should boost the competitiveness of the sector by ensuring that the minimum standards required in the EU are met. As such, additional investments should be made to improve health and sanitation facilities at the landing sites and in fish processing.

The potential of the cotton sector to play a leading role in poverty alleviation is frustrated by a number of challenges, key among them being the low productivity of the sector. This can be improved by ensuring increased access to foreign markets and investment in requisite infrastructure.

Finally, there is scant mention of trade policy and especially its link with poverty in past government strategy documents most of which have been concerned with poverty reduction. All major government development strategy papers should take full account of the impact of trade policies proposed in them on poverty.

About KIPPRA Policy Briefs

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