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Negotiating Trade in Services Under an Economic Partnership Agreement: A Proposal for Kenya

Kenya and other African, Caribbean and Pacific (ACP) countries have enjoyed non-reciprocal preferential trade arrangement with the European Union (EU) since the 1970s under the successive Lomé Conventions. For ACP countries that are not categorized as least developed, Kenya included, the reciprocal preferential trade arrangement with the EU will come to an end at the beginning of 2008. It will be replaced by a reciprocal arrangement in the form of Economic Partnership Agreements (EPAs) between the EU and individual or groupings of ACP countries that are compatible with the World Trade Organization *(WTO)*.

The Cotonou Partnership Agreement (CPA), which provides for negotiation of these EPAs, was signed in the year 2000 and ratified in 2003 by most of the ACP countries. Article 41 of the Cotonou Partnership Agreement provides for the application of special and differential treatment (S&D) in services negotiations. The S&D treatment is in recognition of the wide disparity in capacity and competitiveness between the EU and ACP countries. It is therefore aimed at providing the ACP countries with some sort of affirmative action, through increased openness of EU markets to exports of services from ACP countries, and by strengthening the domestic capacity of ACP countries to supply services.

Although there is no firm obligation under the Cotonou Partnership Agreement for trade in services to be liberalized in the context of the Economic Partnership Agreements, the partnership agreement provides that if the two partners agree to include services in negotiations, then the liberalization of such services should be progressive and adopted to the level of development of the countries involved and to their specific constraints. In other words, the countries have flexibility to exclude sensitive services from the negotiations. In addition, liberalization of trade in services should be guided by the principles of asymmetry and positive regional discrimination; that is, the ACP member countries should not be required to fully reciprocate the openness granted by the EU. This is the spirit of the General Agreement of Trade in Services (GATS) of the WTO.

Kenya and other countries in the region have established a grouping of 16 countries, the Eastern and Southern Africa (ESA)[1], for the purpose of negotiating an Economic

This policy brief is based on a chapter "The effects of the EU-ESA Economic Partnership Agreement (EPA) on Kenya's Services Sector" of a study on Assessment of the Potential Impact of the EU-ESA Economic Partnership Agreement on Kenya's Economy. The study was conducted in 2005/6 by KIPPRA for the Ministry of Trade and Industry under the KEPLOTRADE Programe, which is a trade negotiations support programme. Some data has, however, been updated.

Partnership Agreement with the European Union. ESA countries have agreed to negotiate with the EU on the basis of six clusters, one of them being services. However, the level of preparedness in services negotiations lags behind that of other clusters.

Services are important in Kenya and their importance has increased over time, and currently contribute about two-thirds of the country's gross domestic product (GDP). Equally significant is the fact that the value of exports in services exceeds that of imports, unlike the case of trade in goods. In 2005, for example, services accounted for about 49 percent of foreign exchange inflows and 20 percent of the outflows compared with goods, which accounted for about 52 percent of the inflows and 80 percent of the outflows.

The EU is an important trading partner for Kenya and other ESA countries in services (although we do not have data on this). However, there are considerable barriers in the EU market for Kenya (and other ESA countries) services exports. Trade barriers apart, however, lack of adequate supply capacity has prevented Kenya and other ESA countries from exploiting the EU market. The ESA region is also an important market for Kenya's services exports. Therefore, greater participation of the EU in this market could have significant implications for Kenya in terms of increased competition.

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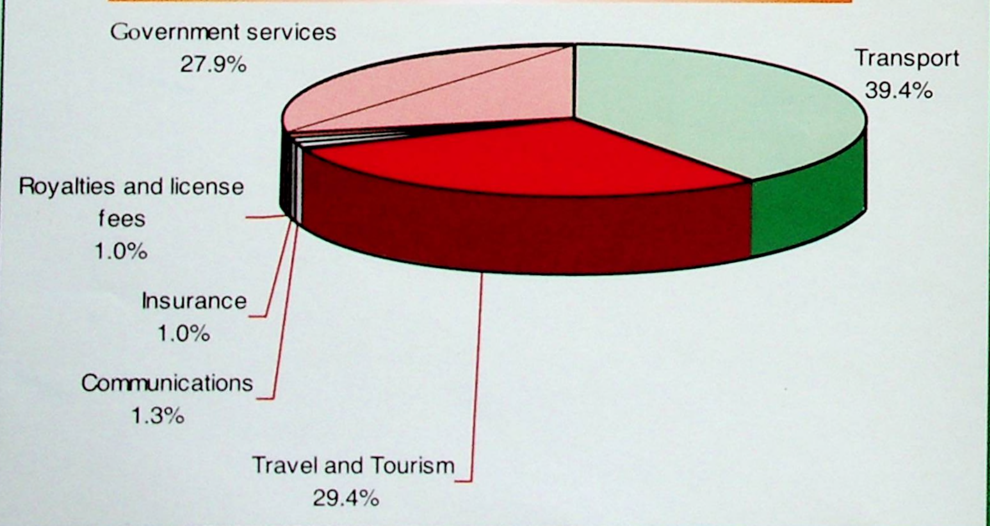
It is therefore evident that Kenya needs to weigh its options in deciding the approach and content of its negotiations for trade in services within the ESA-EU economic partnership agreement. This brief presents a proposal Kenya could consider in developing her position and articulating it at ESA forums. The country could lose the opportunity to expand the existing and potential market for its services exports in the ESA region and the EU if it is not pro-active and strategic in the negotiations.

Importance of Services in Kenya

Since 1960 the contribution of the services sector to Kenya's GDP and wage employment has been much higher than that of either agriculture or manufacturing, with the most

Figure 1:* *Major services exports for Kenya, 2003



Source: Data obtained from United Nations Commission for Trade and Development (UNCTAD: Handbook of Statistics (www.unctad.org) important services being transport, travel and tourism, and communications. In 1960, for instance, the share of services in contribution to GDP was 44 percent compared with 38 percent for agriculture and 18 percent for manufacturing. This share rose to 52 percent by 1990 and to 66 percent by 2004. The sector's share of wage employment in Kenya is even higher.

With regard to exports, the services sector has accounted for over 50 percent of foreign exchange inflows and about 33 percent of the outflows per year for most of the period since the 1970s. In 2004, the respective contributions were 44 percent and 18 percent, while in 2005 they were 49 percent and 20 percent. Apart from government services, the leading commercial services exports are transport, and travel and tourism. In 2003, for example, these two accounted for almost 69 percent of all services exports *(Figure 1)*. Even more important is the fact that efficient and competitive services can spur the growth of other sectors of the economy.

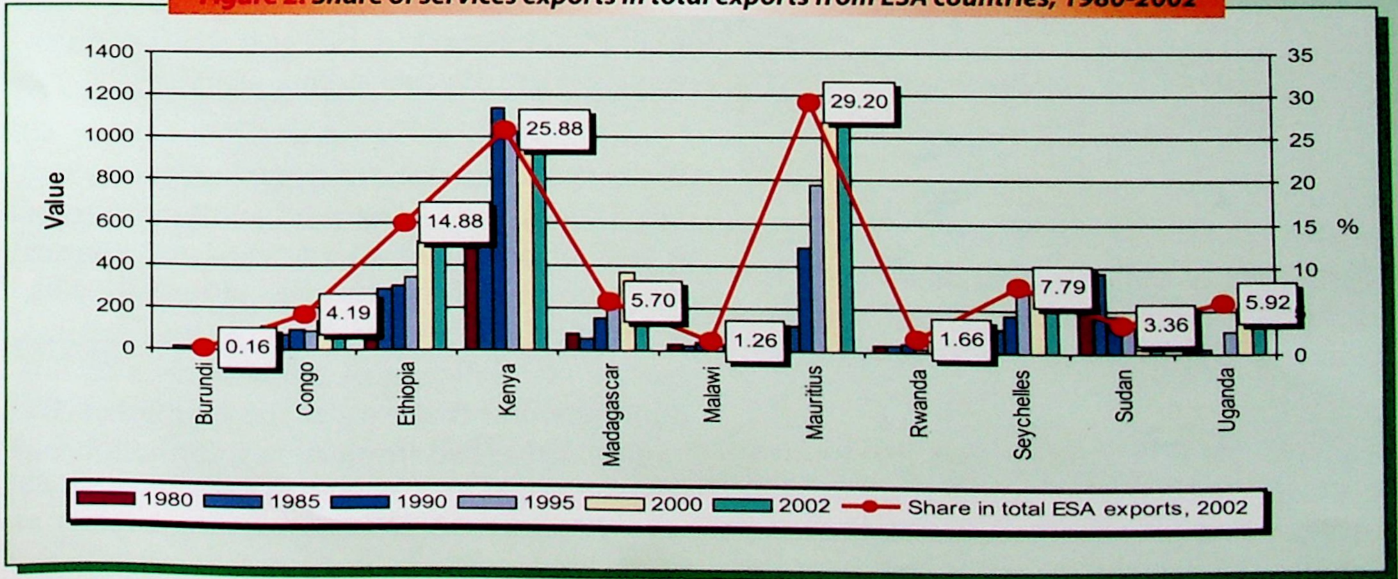
Trade in Services in Kenya and other ESA Countries

The leading exporters of services in the ESA region are Mauritius, Kenya, Ethiopia, Madagascar, Seychelles, and Uganda. In 2002, these countries jointly accounted for close to 90 percent of ESA region's total services exports (excluding those of Comoros, Djibouti, Eritrea, Zambia and Zimbabwe whose data was not available)

Mauritius and Kenya alone accounted for close to 30 percent of the region's services exports that year. Moreover, as Figure 2 demonstrates, the share of services exports in total exports has increased over time for most of the ESA countries. While one or two services dominate the services exports of most of the ESA countries, a few countries export more services. Mauritius mainly exports travel and tourism, transport, insurance, financial and other business services while Kenya exports travel and tourism, transport, and communication services.

While Kenya is among the leading exporters of services among the ESA countries, her ranking has been declining over time and has been overtaken by Mauritius as the leading exporter of services. However, imports of different services into the ESA region (excluding Kenya) have grown considerably since the 1990s, indicating the potential of Kenya to develop into a regional services hub owing to its relatively better endowment in skills and human resources.

***Figure 2:* Share of services exports in total exports from ESA countries, 1980-2002**



Source: Data obtained from United Nations Commission for Trade and Development (UNCTAD): Handbook of Statistics (www.uncatd.org).

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Some of the most important services in the region, in terms of actual or potential trade, are briefly described below.

Travel and tourism

Travel and tourism is a very important export sector for ESA countries, accounting for more than 10 percent of all the countries' (except Djibouti) total services exports in 2003. For a quarter of the ESA countries, in fact, travel and tourism accounts for more than 50 percent of their total exports in services. Many ESA countries have competitive tourism sectors as reflected in indices developed by the World Travel and Tourism Council (WTTC). The competitiveness of Kenya's tourism industry, for example, is largely attributable to the country's environmental and human resource quality, and to some extent technology.

The EU is a critical market for Kenya's travel and tourism exports, accounting for about 60 percent of the tourists visiting the country in any one year. This could be largely true for other ESA countries given the relative proximity of Europe to the region and Europe's demand for tourism services.

Although data on the EU's exports of travel and tourism services to the ESA region is not immediately available, there is likelihood that these exports are not significant, given the high levels of poverty in the region. It is known, nevertheless, that senior government officials and various professionals from the ESA region regularly attend conferences in EU countries.

There are considerable barriers to tourism exports by Kenya and indeed other ESA countries. First are the occasional negative travel advisories issued by EU governments to their citizens. These travel advisories had unprecedented adverse effects on Kenya's tourism between 2002 and 2004.

Second, are the anti-competitive practices of large suppliers who have superior capacity and tend to dominate the market by supplying different services within the travel and tourism supply chain. Such suppliers are found in all segments of tourism and include suppliers of transport, computer reservation and global distribution systems, tour organizers, travel agency and accommodation.

Third, and related to the preceding one, regards the unfair restrictions is access to distribution services like computer reservation systems, the high costs of these systems due to monopolistic tendencies, and tendency of the major airlines that own these services to enjoy privileged access.

Fourth, are barriers over air accessibility, which includes lack of bilateral air service agreements with all EU countries and limitations with respect to the number of passengers that can be airlifted per week in some EU countries.

Finally, the entry of professionals into the EU is still problematic and yet this is the mode of supply that ESA countries have the capacity to exploit. For example, while it requires considerable capital to establish a tour operating business in the EU, it requires much less capital to offer consultancy services.

While the importance of these barriers cannot be underestimated, the most significant barrier is lack of adequate supply capacity. Kenyan firms are unable to compete effectively with their EU counterparts due to capital constraints, difficulty of penetration into the tight networks that exist in the EU markets by foreign firms, and insufficient information on the EU markets.

Transport

Transport services are another important export for ESA countries. In 2003, transport services exports from ESA accounted for about 30 percent of the region's total service exports for that year. All ESA countries exported some transport services that year, with Kenya alone accounting for about 40 percent of the total.

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With respect to transport, the EU and ESA countries trade mainly in air transport and maritime transport services. This is largely because most ESA countries lack capacity in shipping and air transport services. There is strong presence of European carriers such as KLM and British Airways in the region.

However, the value of the intra-regional trade in road, rail, maritime (especially auxiliary and port services), and air transport services is also considerable. Many ESA countries are land-locked and carry out a considerable amount of their international trade through the port of Mombasa. In addition, Kenya Airways has a considerable network of air transport services in the region.

Like in tourism and travel services, therefore, the most important barrier to ESA countries' ability to export transport services to the EU is lack of capacity, and is therefore not market-related.

Other services

Other important services in the ESA region, although they are not featuring among the leading exports, include professional services and telecommunication services. These are not only important and strategic in these countries' economies but also have a high export potential especially in the regional context. As an example of this potential, some ESA countries have a surplus supply of professional services while others have large deficits. There is therefore increasing evidence of growing regional and overseas movement of professionals from Kenya and other ESA countries that have a surplus. The main destinations of Kenyan professional service exports in the last decade have been Southern and Eastern Africa regions, although many others have sought opportunities in the UK and other European countries.

The regional market is expected to continue to be an important export destination for Kenya's professional services in the coming decades. However, as discussed under tourism, movement of professionals is highly restricted in the EU due to many licensing and visa requirements. Relaxation of such restrictions would therefore have an enormous positive impact on the economies of ESA countries, more so if the relatively lower skilled staff were allowed to accompany professionals.

With improving telecommunication services, moreover, Kenya has potential to become a global outsourcing centre for Information Communication Technology (ICT) and manufactured products. The potential is based on the country's relative advantages with respect to human resource, time differences with the USA, geographical proximity to Europe, and the widespread use of English language in the country.

Although accurate data is not available, other services are known to be important, or have potential tradables, for some ESA countries. Kenya, for example, imports a large amount of education services from the USA, EU, South Africa and even from the neighbouring countries. KIPPRA estimates that the country pays about Ksh 25 billion annually for these services. However, the country also exports education services in the region and has potential to become a regional hub for these services. This is also true for health services, and medical institutions in Nairobi are handling increased numbers of patients from the region

Overall, therefore, services are an increasingly important export sector not only in Kenya but also in other ESA countries. The EU and ESA regions are important trading partners in services. However, there are considerable barriers in the EU market for exports of services by ESA countries. Reduction or removal of these barriers would considerably benefit the region. The greatest barrier in most cases is not market access but lack of supply capacity.

Implications of an ESA-EU Economic Partnership Agreement (EPA) to Kenya

From the foregoing, and from available literature, several features that indicate the likely implications of an economic partnership agreement between ESA countries and the EU emerge.

The economic partnership agreement may not necessarily lead to an immediate explosion of EU export of services into the ESA region. Yet, depending on how the negotiations are done, the EPA could provide considerable resources for addressing domestic supply bottlenecks and attract investment by EU firms.

First, there is considerable presence of EU firms in Kenya's services industry largely due to many years of friendly policies. These firms include Barclays, Citibank and Standard Chartered in banking; Deloitte Touche, Tohmatsu and KPMG in accounting, auditing and consulting; Ayton Young & Rubicam in advertising and marketing; Maersk, Express Kenya, Interfreight, and Tibbett & Britten in transport and logistics; Old Mutual in insurance; Symbion in architecture and interior design; Securicor in other business services; foreign independent power producers (IPPs) in energy; Vodafone and Celtel in mobile phone sector, and many others in education, tourism and other sectors. Many of these and other service providers use Kenya as their regional hub.

Second, barriers to EU firms in the Kenyan and ESA market in general are not significant. Even though many countries in the region have not made deep commitments within the WTO/GATS framework, they have considerably liberalized their services through structural adjustment programmes (SAPs) and other initiatives.

Third, major barriers exist in the EU for ESA services exports, especially in professional services.

Fourth, the domestic supply capacity of services in many ESA countries is weak.

In view of these features and the nature of past and current trade in services between the EU and ESA, the economic partnership agreement may not necessarily lead to an immediate explosion of EU export of services into the ESA region. Yet, depending on how the negotiations are done, the EPA could provide considerable resources for addressing domestic supply bottlenecks and attract investment by EU firms. This should inform Kenya's approach to and content of the ESA-EU economic partnership negotiations with respect to services.

A Proposal for the EPA Negotiations

This brief makes a proposal on how Kenya could approach the negotiations for ESA-EU economic partnership agreement for services. The proposal consists of what Kenya (and other ESA countries) could request from the EU; what they could offer to the EU; and how Kenya could exploit the regional potential to build international competitiveness.

What Kenya and other ESA countries could request

The EU has already committed itself to special and differential treatment for the ESA and other ACP countries in the negotiations, and to support the development of their services sectors. Kenya and other ESA countries should therefore negotiate for, among others:

- Adequate and flexible resources, both in the form of financial support and technical assistance, to develop the capacity for supply of domestic services. Such capacity is required across the range of services in the form of infrastructure development and other requirements for improving the business environment. This should include support for the relatively small-scale businesses to establish commercial presence in the EU, as a way of coping with pressure from the large integrated suppliers.

- Substantial improvement of EU's openness to services exports from Kenya and other ESA countries, especially with respect to temporary entry of professionals from the region. This could be achieved through introduction of a business travel card to ease the visa process; inclusion of less-skilled workers in the list of support staff allowed to accompany professionals entering the EU to supply services; recognition of professional qualifications of service suppliers from the ESA region through special pass or similar arrangements; increased supply of information regarding the EU market in terms of the demand for services and the trade barriers in existence; adoption of measures by the EU to discourage unfair and anti-competitive practices such as domination by large integrated suppliers; and removal of the restrictions that limit the ability of ESA service suppliers to establish businesses in the EU.

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- Full credit for autonomous liberalization, that is, for the liberalization of services trade that ESA countries have already undertaken either through structural adjustment programmes or their own initiatives.

- Adoption by the EU of measures or incentives to stimulate the right kind of foreign direct investment and therefore increased technology transfer from the EU to ESA countries.

- Emergency safeguards in case of balance of payments problems or other unanticipated outcomes arising from the economic partnership agreements.

Kenya should take a pro-active approach and leadership role to ensure that these elements are included in the negotiations.

What Kenya and other ESA Countries could offer

Kenya should offer, or promise to offer after a specified period, further liberalization of services that it lacks capacity to supply immediately or within a short period. A growing body of research suggests that these may include basic telecommunications and shipping services. However, conditions should be attached to such offers. Such conditions include transfer of technology and managerial know-how, public service obligations, maximum prices that can be charged for essential services such as water and sanitation, and the proportion of profits that must be reinvested in the infrastructure.

Exploiting regional potential

Kenya should adopt measures to take advantage of its regional competitive advantage in skills and human resources to strengthen its standing as a regional services hub and to develop into a global outsourcing centre. This requires attracting investment in critical areas such as rebuilding of infrastructure (including roads, energy and telecommunications) and creation of a competitive environment for the private sector; improvement of security, law and order; and further supply of the required skills, including through improvement in education, partnership with the private sector, and attraction of qualified Kenyans in the diaspora to join in through investment. Efforts in this direction should also include relaxation of the minimum capital requirement of $500,000 in the Investments Act 2004 for services, which require relatively little capital. The efforts should also include tax incentives such as reduced corporate and withholding tax rates, relief from double taxation of income, and extension of the 'investment deduction' incentive available to manufacturing and tourism to other services. These interventions have also been recently recommended by UNCTAD.[3]

Notes

[1]ESA countries are Burundi, Comoros, DR Congo, Djibouti, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Uganda, Zambia, and Zimbabwe.

[2]However, Zimbabwe was among the leading exporters in 2000 for transport, travel and tourism and business services.
[3]UNCTAD (2005). Kenya Investment Policy Review, UNCTAD, Geneva.

About KIPPRA Policy Briefs

KIPPRA Policy Briefs are aimed at a wide dissemination of the Institute's policy research findings. The findings are expected to stimulate discussion and also build capacity in the public policy making process in Kenya.

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