

# Development Discussion Papers

## **Export Platforms in Kenya**

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## Export Platforms in Kenya

Graham Glenday and David Ndi

### Abstract

The paper analyses the structure and performance of export platforms in Kenya over the past decade. Kenya has three types of export platform. Two are targeted at export-dedicated businesses: manufacturing under bond (MUB) and export processing zones (EPZ). The third is a generalized and flexible export support program providing import duty exemptions for imported inputs into the production of exports and duty free goods for the domestic market. A stylized theoretical framework is presented to explore the structural features of different platform designs. The actual use of the three platforms in Kenya is analyzed using administrative and customs data. The changes in the macroeconomic policy environment are also analyzed in terms of the impact on export competitiveness and the composition and direction of exports.

Macroeconomic reforms, trade liberalization measures, and regional integration have been the key factors behind fluctuations in Kenya's manufactured exports. The export surge recorded in the 1993-95 period coincided with a sharp depreciation of the Kenya shilling, a significant fall in the real average wage, and a major shift in the trade regime following the abolition of trade licensing and foreign exchange allocations in 1993. These favourable export conditions were not sustained, and export performance deteriorated again significantly after 1996.

The preferential regional market, primarily Uganda and Tanzania, followed by the wider Common Market for Eastern and Southern Africa (COMESA) accounted for the dominant share of the increase in Kenya's exports after 1993, especially manufactured exports, reflecting a major diversion in trade. Besides the regional economic integration initiative, this trend is also a reflection of economic recovery and trade liberalization in the region increasing demand for Kenyan manufactures.

The export-dedicated MUB and EPZ platforms, targeting overseas markets, have been inconspicuous, with their combined cumulative share of exports over 1993-1998 amounting to just over one percent of total exports. By contrast, exporters using the more flexible duty exemption programme have averaged 35 percent of total exports, or over 50 percent of the eligible processed and packaged exports, and over 75 percent of exports of manufactures, largely targeted at the regional market. The unfavorable macroeconomic conditions have largely kept Kenya out of the labor-intensive manufactures, notably garments, footwear and light assemblies, for the world market using dedicated export platforms.

**Keywords:** Kenya, export platforms, export processing zones, export promotion, duty exemptions

**JEL codes:** F13, H25

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## Export Platforms in Kenya<sup>1</sup>

### 1. Introduction

Kenya embarked on trade liberalization and export promotion programmes in 1987 in response to a deterioration of export performance over the preceding decade. Merchandise export earnings as a percentage of GDP declined from 19.6 % the 1970s, to 16.97 % over 1980-84 and a further 13.6 % over 1985-89 (reaching an all time low of 11.5% in 1987). Exports surged dramatically in the early nineties, particularly after 1992. Three export promotion schemes, or platforms, were introduced to promote labour-intensive manufactures, namely a bonded warehouse or manufacturing under bond scheme (MUB), Export Processing Zones (EPZs), both targeting new investments, a duty and VAT exemption scheme (known by the acronym EPPPO for Export Promotion Programmes Office), targeting existing manufacturers. Following these initiatives, export earnings jumped from 13 % of GDP in 1992 to over 20 % between 1993 and 1996.

Export platforms are often cited as critical elements of successful entry into developed country markets for labour-intensive manufactures by the Asian “Tiger” economies, the Philippines, and Mauritius in Africa among others. However, the research evidence has thus far not established whether export platforms have been an essential leverage for this success or the “icing on the cake,” in other words, an appropriate policy regime—outward orientation, macroeconomic stability and labour cost competitiveness—would have been sufficient. This study evaluates the role and performance of Kenya’s export platforms in this context. It is organized in six sections, as follows. The rest of this section presents a synopsis of the main findings. Section Two discusses export platform structure, design issues and operational issues, using a stylized analytical framework. Sections Three and Four provide an overview of implementation and performance of Kenya’s export platforms. Section Five analyses this performance in the context of the macroeconomic policy environment and its impact on overall export performance, focussing on trade liberalization, the real exchange rate, labor costs and productivity, and Section Six draws conclusions from Kenya’s experience on the potential for export platforms in Sub-Saharan Africa and similar countries.

#### *Summary of Main Findings.*

Macroeconomic reforms, trade liberalization measures and regional integration have been the key factors behind the recovery of Kenya’s manufactured exports. The export surge recorded in the 1992-1994 period coincides with a sharp depreciation of the Kenya shilling (a 25 percent real depreciation of the Ksh/US\$ exchange rate from 1990 to 1993), an even more significant fall in the real average wage (by 39 percent over the same period), and a major shift in the trade regime following the abolition of trade licensing requirements and foreign exchange allocations and restrictions. These favourable export conditions have not been sustained as both the real Ksh/US\$ exchange rate and the average wage rate in US\$ terms by 1997 had reverted to pre-1990 levels and then, in the case of the exchange rate, exceeded them, which in turn explains the deteriorating export performance after 1996.

The preferential regional market, led by Uganda and Tanzania (partners in the East African Cooperation trading bloc), followed by the wider Common Market for Eastern and Southern Africa (COMESA) accounts for the dominant share of the increase in Kenya’s exports. In fact, the preferential

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regional market has absorbed over 100 percent of the cumulative increase in processed exports over the 1993-1998, reflecting diversion of trade from the rest of the world to the preferential regional market. Non-COMESA markets accounted for 95 percent of the increase in primary goods exports over the same period. Overall, recorded exports to COMESA increased from a 1990-92 average of 15 percent of the total, to 34 percent in 1996-98. Uganda's share alone increased from 6 percent of the total to 15 percent and Tanzania's from 3 percent to 12 percent, in effect, to a combined share of close to a third of Kenya's total exports. Besides the regional economic integration initiative, this trend is also a reflection of economic recovery and trade liberalization in the region, hence an overall increase in import demand, alongside a down turn in the Kenyan economy, hence an added impetus for Kenyan firms to seek external markets.

Not surprisingly then, the impact of MUB and EPZ platforms, designed to target dedicated export processors for overseas markets, has been, by and large, inconspicuous among exports. The combined cumulative share of exports originating from MUB/EPZ enterprises over 1993-1998 amounts to just over one percent of total exports. By contrast, exporters using the more flexible EPPO duty/VAT exemption programme have averaged 35 percent of total exports, which we estimate to be over 50 percent of the processed and packaged exports eligible for EPPO, and over 75 percent of exports of manufactures. However, utilization of the EPPO programme has been declining, from a peak share of 38 percent in 1994 to 31 percent in 1998, reflecting exports declining with the erosion in competitiveness through exchange rate and real wage appreciation as well as the tax value of the programme declining with lower duty rates. That said, the MUB platform did show considerable potential. The facility become an attractive platform for contract garment manufacturing for the US market, but this suffered a major setback in 1994 when the US trade authorities revoked Kenya's quota for some items (shirts, tee shirts and pillow cases) citing transshipment of garments originating from India through Kenya. By 1997, only 10 garment factories were in operation, out of over 70 in operation at the time of the quota restriction. But even if the quota had not been revoked, the success might not have been sustained on account of the subsequent appreciation of both the exchange rate and the real wage, and latterly, the precipitous fall of South East Asian currencies and labour costs following the financial crisis.

Kenya has a relatively large skilled and semi-skilled industrial labour force that could be readily engaged to produce labour-intensive manufactures, notably garments and footwear, for the world market. A large proportion of this labour force is engaged in a dynamic and highly competitive informal sector (somewhat analogous to Asia's "sweat shops"), where earnings are significantly lower than formal sector wages, but unlike Asia, Kenya has not been able to translate this dynamism and wage competitiveness into labour-intensive export processing. Reliance on physical, rather than accounting controls and high transactions costs imposed by excessive bureaucracy in the administration of Kenya's export platforms constitute entry barriers for informal sector, either as direct exporters or through subcontracting arrangements with formal sector exporters.

## 2. Theoretical framework

The core of most export promotion schemes is to provide the inputs to the production of exports at world prices. This recognizes that exports generally only earn world or border prices for the exporter. Lowering the costs of tradeable inputs at least to their world or border price levels is important to gain export price competitiveness for the exporter.

Another way of expressing this objective is: the export promotion schemes aim to remove any *negative* trade protection from exports. By contrast with import-competing products, which mostly receive *positive* trade protection or a *net subsidy* from import tariffs, exports typically suffer from a disincentive from trade protection through import tariffs. An explicit derivation of the net subsidy provided tradable

goods by import tariffs provides a useful framework for understanding the different types of export promotion scheme.

The net rents or pure profits ( $\bullet$ ) of a business venture selling quantity,  $Q$ , at a price inclusive of import tariffs of  $p(1 + \tau_Q)$  after incurring labor and other non-tradeable costs of  $wL$ , tradeable variable input costs inclusive of import tariffs of  $mM(1 + \tau_M)$ , and capital rental costs, gross of taxes on the capital income or on the capital assets and inclusive of import tariffs, of  $(r + \delta + t_k)K(1 + \tau_k)$  are given as:<sup>2</sup>

$$\bullet_1 = pQ(1 + \tau_Q) - [wL + mM(1 + \tau_M) + (r + \delta + t_k)K(1 + \tau_k)] \quad (A)$$

where  $p$ ,  $Q$  and  $\tau_Q$  are the world price, quantity and tariff rate of the product;  $m$ ,  $M$  and  $\tau_M$  are the world price, quantity and tariff rate of tradeable variable inputs;  $r$ ,  $\delta$ ,  $t_k$  and  $K$  are the rental rate, depreciation rate, tax rate and capital value of capital assets, respectively. The world prices are expressed in domestic currency at the current market exchange rate.

At world prices, excluding import tariffs, the net rents from the business would be:

$$\bullet_0 = pQ - [wL + mM + (r + \delta + t_k)K] \quad (B)$$

The net subsidy received by the business from the tariff protection is the difference ( $\bullet_1 - \bullet_0$ ) or

$$S = pQ - [mM + (r + \delta + t_k)K] \quad (C)$$

This net subsidy can be expressed relative to the value of the product sales at world prices as:

$$s = \tau_Q - [\alpha_M \tau_M + (\alpha_K + \alpha_t) \tau_k] \quad (D)$$

where the  $\alpha$ 's are essentially the cost shares of tradeable variable inputs, net-of-tax capital rental cost and capital taxes, respectively.

For most import-competing goods, the net subsidy is positive with  $\tau_Q \geq \tau_M$  and  $\tau_k$ . If the product is exported, or can be imported duty free, or is sold to an aid-funded project or any other buyer with duty-free privileges at a duty-free price, then the subsidy becomes *negative* with  $\tau_Q = 0$  or

$$s = - [\alpha_M \tau_M + (\alpha_K + \alpha_t) \tau_k] \quad (E)$$

To avoid this negative subsidy or negative protection, export promotion programs or export platforms typically make  $\tau_M$  on tradeable variable or current cost inputs zero, and sometimes also make  $\tau_k$  on tradeable capital equipment zero. The removal of the cost of the import duty content is achieved through duty exemptions, or through drawbacks or some compensation payments for the duty content. In some cases, export promotion programs or platforms will also reduce the effective taxes on the capital income (hence the share of capital taxes,  $\alpha_t$ , is reduced below that normally charged on domestic businesses.) The value of the export program is reduced to the exporter by the transaction costs of

<sup>2</sup> It is assumed here that all sales taxes or VATs on consumption are neutral with respect to net rents. This is achieved variously under different consumption tax structures. Under an exemption or ring-method general sales tax, it is assumed that capital equipment, raw material and taxable services are exempt inputs into the production of taxable goods (including exports.) Similarly, under a credit-method consumption VAT, it is assumed that all input VATs are deductible against output VAT, or are otherwise creditable and refundable if the input VAT exceeds the output VAT. In some export promotion programs, certain exporters may be able to purchase inputs zero rated to avoid financing the input VAT while waiting for the refund or credit payment.

complying with the program. In addition, the economy suffers the added cost of the administration of the program by the government. Each of these program elements is discussed separately below.

Alternatively, general reductions in import tariff rates can reduce the need for specific export promotion programs. General reductions in import tariffs, however, will also have different effects on the exchange rate than specific export programs. Generally, the domestic currency is expected to devalue with general import tariff reductions. This will favor the production of tradeables, including exports. The lower average import tariff rates in an economy, the less the justification for incurring the transaction costs associated with compliance and administration of export promotion programs. If use of the program is voluntary, then as tariff rates are lowered, some export firms may opt out of using the program if the compliance costs exceed the program benefits. As will also be further discussed below, use of a particular export program or platform may also place other restrictions on a business that result in added costs that discourage its use.

#### *Import tariffs on tradeable variable inputs*

$\tau_M$  can be zeroed through either import duty exemptions or drawbacks for inputs used in the production of exports, duty free goods or goods sold to domestic persons with duty free privileges. Where the producer of the goods exports own-produced goods, the firm is referred to as a *direct exporter*. Where tradeable inputs are purchased from domestic suppliers rather than imported directly by the exporter, such domestic input suppliers are referred to as *indirect exporters*. Indirect exporters also need their negative protection removed by import duty exemptions or drawbacks based on sales to exporters, if they are to sell to exporters at world or border prices. The direct exporter always has the option of importing the input duty free rather than purchasing from a domestic producer or indirect exporter. Such first-stage indirect exporters may, in turn, either import inputs directly or purchase them from domestic suppliers which could be referred to as second stage indirect exporters. Such second stage indirect exporters could be offered duty exemptions or drawbacks on imported inputs used to produce inputs to a first stage indirect exporter that supplies inputs to an exporter. In theory, this chain of indirect exporters could be lengthy. In practice, it seldom goes back more than three or four stages.

This problem of complex chains of input-output relationships in the chain of supply leads to two potential strategies for removing the price-raising effects import tariffs on inputs. One is to remove the actual duties paid at each stage of inputs ultimately going into the production of exports. The other is to establish estimated import tariff content in all different types of exports and compensate the final exporter for the implicit estimated tariff content. The issues involved in each approach are discussed below.

#### *Import tariffs on capital investments*

Not all export promotion programs offer to remove the cost of import tariffs on capital equipment or other capital investments (or set  $\tau_{\geq k}$  to zero). The reason for this is that not all production of a company necessarily goes into exports. Where the export share of production is low and the product receives import protection, lowering the import tariffs on all capital investments merely raises the effective subsidy received from supplying the domestic market. (See expression (D) above.) As result, unless an export program is targeted at companies producing primarily for export, a duty exemption for capital imports is often not offered, or alternatively, under some programs import duty is charged on domestic sales if all inputs, current and capital received import duty exemptions. Further, where estimated import duty contents are paid upon export of a particular class of goods, then compensation for the import duty cost of capital investments can be included in an aggregate compensation payment rate on the export. This is discussed further below. Alternatively, countries may offer import duty exemption on capital goods under some more general investment promotion program which would include investments for export production as only one of the eligible classes of investment.

### *Reducing effective taxes on capital income*

Reductions in the effective tax rates on capital income are offered under certain export promotion programs. These income tax incentives may take the form of tax holidays, lower tax rates, exemption on export-derived income, accelerated depreciation, increased investment deductions or reduced property tax rates. In line with the considerations for exempting import duties on capital goods, these income tax incentives are typically also limited to companies producing primarily for export to avoid increasing the effective protection of domestic production. Note if the promotion program lowered the effective tax rate from  $\tau_k$  to  $\tau_k'$  and corresponding the share of capital taxes from  $\alpha_t$  to  $\alpha_t'$ , then the effective subsidy rate in (D) becomes:

$$s = \tau_Q - [\alpha_M \tau_M + (\alpha_K + \alpha_t') \tau_k + (\alpha_t' - \alpha_t)] \quad (F)$$

The subsidy rate on export producers is therefore increased by  $(\alpha_t - \alpha_t')(1 + \tau_k)$ . Again, instead of offering special income tax incentives to export producers, these incentives may be part of a broader investment incentive program available to both export and domestic sector producers, in which case  $\alpha_t = \alpha_t'$  and the bias towards export production is removed. This approach is becoming more common given that income tax incentives confined to exporters are generally prohibited export subsidies under WTO/GATT rules and can generate countervailing duties in importing countries showing damage from the subsidized exports.

### *Value of flexibility and options in export production*

While different export platforms aim to remove the effective export disincentives from import tariffs charged on production inputs, and sometimes go further to provide income tax incentives for exporters, these programs often impose added restrictions on the locational choice and the costs of non-tradeable input requirements. To illustrate, an Export Processing Zone program that offers full import duty exemptions and other tax incentives, but is limited to firms producing primarily for export and also limits the range of locations for conducting business can result in increases in other input costs such as transport, utilities, land, buildings, or labor as well as program and tax compliance costs. They also remove future options to redirect sales to the domestic market in the future. This can result in lower capacity utilization of plant and equipment that raises unit costs. Restrictions on location can also affect domestic transport costs on tradeable goods as well. These real input and option costs may more than offset the tax benefits of doing business in an Export Processing Zone. These issues will be important in comparing the different export platforms offered in Kenya and their success and usage.

These costs of restricting the flexibility in production choices, therefore, raise the real costs of using a particular export program. This means that the real costs of labor and other inputs and also the related costs shares (in terms of the value of the production at world prices) in the case of using the program may be higher than the without program case. The costs in the case of operating within an export program are denoted with a prime mark. In addition, the costs of compliance with the program as a share of production value are given as  $\beta$ . With these adjustments, the net gain from participation in an export program offering  $\tau_M = \tau_k = 0$  becomes:

$$\Delta = [\alpha_M \tau_M + (\alpha_K + \alpha_t) \tau_k] + [(\alpha_L - \alpha_L') + (\alpha_M - \alpha_M') + (\alpha_K + \alpha_t - \alpha_K' - \alpha_t') - \beta] \quad (G)$$

### *Real exchange rate effects*

The pure profits of a domestic manufacturer of tradeables are above in (A) in terms of world prices expressed in domestic currency units. These prices could alternatively be expressed in terms of world prices in foreign currency units and the exchange rate of the domestic currency per unit of foreign

currency. For example,  $p = p^w E$ , where  $p^w$  is the world price in foreign currency units and  $E$  is the exchange rate in domestic currency per foreign currency. Only the price of non-tradeables,  $w$ , does not depend directly on the exchange rate,  $E$ . Hence, if the pure profits in (A) are restated as a share of the revenues at world prices,  $pQ$ , as follows:

$$\pi_i / (pQ) = (1 + \tau_Q) - [\alpha_M(1 + \tau_M) + (\alpha_K + \alpha_L)(1 + \tau_K)] - wL / (p^w E Q) \quad (H)$$

then it is clear that the pure profits rise with a devaluation in the domestic currency ( $E$  rises) as relative cost of non-tradeables in the last term of (H) falls. This expression also shows that if all the effective import duty rates,  $\tau$ , decline, then the pure profits will decline for manufacturers of importables, but increase for manufacturers of exportables (with  $\tau_Q = 0$ ). If the average duty rate on imports declines, however, then trade will expand and the exchange rate will devalue. For manufacturers of importables, this increase in  $E$  will partially offset the decline in effective tariff, while for manufacturers of exportables, the devaluation will further enhance their profitability. General reductions in average import duty rates, therefore, can be expected to improve the prospects of producers of exportables both directly through the reduction in the import duty content of their costs as well as indirectly through the exchange rate lowering the relative cost of non-tradeable inputs. Lower average duty rates can also be expected to result in lower benefits from using export platforms that provide exemptions for import duties on inputs, and hence, fewer firms will find the benefits of export platforms exceeding the compliance and other costs of using them. Trade liberalizations is expected to lead to lower usage of export platforms.

Expression (H) also illustrates that manufacturers with higher domestic value added will be more concerned by the macroeconomic market conditions, particularly wages and the exchange rate (or  $w/E$ , the foreign currency cost of domestic labor), while those with low domestic value added will focus on their effective tariff protection. Low domestic value added manufacturers will be very sensitive to the rate of output protection ( $\tau_Q$ ) relative to input duties ( $\tau_M$ ). Such manufacturers will be more sensitive to the availability of export platforms if they are to enter the export business.

### *Regional markets and treatment of intra-regional exports*

As discussed above, the core function of an export platform is to remove the import duty costs from exports that will be sold at world prices in unprotected markets. Ideally, if a country is a member of a common market, for customs purposes all member countries are treated as one country. The common market members have a single common tariff charged on imports from all external countries (a so called "common external tariff") but no duties are charged on trade within the region. The corollary is that such intra-common market exports are treated as domestic sales behind the common tariff protective wall and, hence, do not qualify as exports under any export promotion program as they already receive the subsidization benefits of the common external tariff. This would imply that intra-regional exports would receive the same effective subsidy from tariff protection as would production for the domestic market, as given in expression (D) above.

This ideal situation, however, has not applied in the case of Kenya and other members of the Common Market for Eastern and Southern Africa (COMESA.) Intra-regional tariffs have been systematically reduced during the 1990s such that most trade between members of COMESA countries on goods originating from a member country now only pays a duty rate of about 10% to 20% of the regular rate. While some attempt has been made to harmonize tariff schedules of member countries, these are still far from a common external tariff. In addition, trade between member countries are still generally treated as imports or exports for purposes of export promotion programs. This means that exports to other member countries receive a *higher effective subsidy* if they are supported by an export platform that do sales to the domestic market. This arises because intra-regional exports are sold behind the wall of

tariff protection, but get exemptions or drawbacks of duties on imported raw materials. If the removal of import duties from inputs is complete ( $\tau_M$  and  $\tau_K = 0$ ), the effective subsidy rate given by (D) rises to the import duty rate on the good exported within the region, that is,  $\tau_s = \tau_Q$ . This means that the export platform biases sales in favor of intra-regional exports over exports to external countries and could cause significant trade diversion within the region. If the exemption only applies to raw materials and not to capital goods, then the effective subsidy is somewhat reduced to:  $s = \tau_Q - (\alpha_K + \alpha_I) \tau_K$ . Exports from an Export Processing Zone (EPZ) can be an exception as the EPZ is typically regarded as being outside of the customs territory of the home country. Therefore, EPZ exports may not qualify as originating from home country, and hence, not qualify for preferential tariff treatment by the importing country.

It is difficult for any one member of a common market to withdraw unilaterally export promotion benefits for intra-regional exports in order to remove this trade diversion incentive. This normally has to be achieved by joint action. A common market usually operates with one customs code for all members – all use the same law, regulations, procedures and tariff schedule. Under this type of arrangement, the customs territory expands to include the territory of all member countries and exports and imports are only recognized with countries external to the common market. COMESA and more recently the East African Co-operation arrangements have not yet reached the stage of defining a common external tariff or a common customs code although work is proceeding in that direction.

*Removing actual versus estimated import duty content in exports*

Before discussing the actual export platforms provided in Kenya, it is useful to give some background on some of the choices in strategy for designing and administering mechanisms for remove the import duty content from exports. As noted above, where a domestic firm purchases tradeable inputs from other domestic firms (rather than importing them directly) problems arise with identifying and removing the full import duty content in the inputs. Multiple stages of domestic production may be involved which involve tradeable inputs but not direct imports. This makes the exemption or drawback of actual duties paid inadequate to bring input prices back to border prices. In addition, where a domestic firm both exports and sells into the domestic market, only removing the duty content in capital assets consumed in producing the exports poses a challenge. In particular, a duty exemption on capital goods presupposes the goods will be used to produce exports only. After the fact this may not prove to be the case. While WTO/GATT rules, in fact, require only actual duties paid on inputs physically incorporated in the export to be exempted or drawn back, countries have resorted to estimated import duty contents on specified classes of exports to compensate the exporter for the price-raising effects of import tariffs on inputs used directly or indirectly in producing the export. Detailed studies of tradeable input contents of exports can be undertaken using input-output data and/or industrial surveys of the production, costs and effective import tariffs. While in theory this approach can deal with the problems of indirect supply and partial use of capital assets in producing exports, in practice it is difficult to apply and has unintended outcomes.

Estimating the appropriate compensation rate on exports for implicit duties on input costs suffers from a number of problems. First, for any one class of exports, different producers vary the input mixes and have different levels of technical efficiency in using inputs, such as levels of wastage. Second, within any class of goods, there will be significant variety of products in terms of size, quality, materials employed, etc. These factors will result in a variation in the true compensation rates around the estimated rate such that both over and under compensation for the effects of tariffs on input prices will arise. Over compensation is fiscally expensive and may generate countervailing action from importing countries. Under compensation blunts the effectiveness of the program. A second problem with the approach of using estimated compensation rates by types of export is that it requires a major up front and ongoing investment in measuring input usage requirements and effective tariff rates on all inputs for a huge number of export goods. The resource and information requirements to develop and maintain this

information are considerable and costly. Without this effort, significant errors will grow over time in the compensation rates for different exports. In the extreme, the use of a single compensation rate for all manufactured exports, as used in Kenya for a number of years, avoids these administrative costs, but also guarantees both significant over and under-compensation for import duty content in the inputs.

By contrast, programs exempting or drawback actual import duties are generally based on self-assessment of the import duty content which is then policed by random verification exercises. This allows rapid program start up (no prior investment in industrial information on input cost content and effective tariffs are required) and much of the administrative burden is put on the program users. Only compensating actual duties paid will tend to constrain the program fiscal cost, but will also tend to under-compensate export producers, and seldom, if ever, over-compensate them. Actual duty exemption or drawback also has difficulty in dealing with capital costs unless production is primarily for export. Exemption or drawback of duty on capital investments tends to be limited to companies primarily producing for export.

From the above, it is clear that exemption and drawback programs that focus of the actual duties paid by a direct exporter will not remove the entire import duty content from costs to the extent that tradeable inputs are purchased from domestic manufacturers or to the extent that the prices of non-tradeables also contain duty content. Extending the program to indirect exporters can reduce the effective duty content, but some residual effective duty is expected to remain so that effectively  $\tau_M$  and  $\tau_K$  are not reduced all the way to zero by the program.

### *Choice of export platform*

While export platforms are generally designed to remove the negative protection expressed in (E) or provide the net gain given in (G) above through import duty exemptions or drawbacks on raw materials and also possibly capital equipment, and also through income tax incentives, it is noted above that participation in an export promotion program may result in increased real costs of inputs or added compliance costs. In addition, the removal of the import duty costs may only be partial, dampening the benefits. Therefore, an exporter may not decide to use an export platform. This should happen when an exporter finds that the pure profits, as given in (A), exceed the pure profits gained from using an export platform. If the pure profits are expressed as a share of the revenues at world prices, then *without* a platform, the pure profit share is:

$$\pi_1/(pQ) = (1 + \tau_Q) - [\alpha_L + \alpha_M(1 + \tau_M) + (\alpha_K + \alpha_t)(1 + \tau_K)] \quad (I)$$

while *with* a platform, the pure profit share is:

$$\pi_1'/(pQ) = (1 + \tau_Q) - [\alpha_L' + \alpha_M'(1 + \tau_M') + (\alpha_K' + \alpha_t')(1 + \tau_K') + \beta] \quad (J)$$

Each component of the costs can differ when an export platform is used compared to the situation in which no platform is used. All the cost variables in (J), therefore, are marked with a prime.

An exporter will be expected to use an export platform if pure profits in (J) exceed those in (I). Taking the difference between (J) and (I) as gives:

$$\begin{aligned} \Delta &= (\alpha_L - \alpha_L') + (\alpha_M - \alpha_M') + (\alpha_K - \alpha_K') + (\alpha_t - \alpha_t') - \beta \\ &\quad + (\alpha_M \tau_M - \alpha_M' \tau_M') + (\alpha_K \tau_K - \alpha_K' \tau_K') + (\alpha_t \tau_K - \alpha_t' \tau_K') \end{aligned} \quad (K)$$

An exporter is expected to choose to use an export platform if  $\Delta$  is positive. In the ideal case, where there are no added compliance costs or income tax effects, and where all the input duty costs are removed, (K) reduces to:

$$\Delta = \alpha_M \tau_M + (\alpha_K + \alpha_I) \tau_K \quad (L)$$

which clearly has a positive value as long as there are effective import duties on the inputs and ,hence, exporters can be expected to use such an export platform. This, however, generally will not be the case. On the one hand, compliance costs can be reduced by lowering licence fees, improving access to foreign exchange or serviced land, and increasing the speed and certainty of obtaining licences or approvals for investment. On the other hand, costs can be increased by restricting choices of location that affect costs of labor, utilities and transportation, higher rents, increased reporting and inspection requirements, bringing a business into the formal tax net (which may also affect tax compliance in related businesses) or restricting its flexibility in product and volume of production choices in response to market demand shifts that would lower its capacity utilization and raise its unit costs. These potentially negative aspects of export platforms, especially the less flexible, export-dedicated platforms, are more likely to be outweighed when the duty reductions on capital equipment and raw materials are large and the shares of costs on imported equipment and raw materials are large. For example, footloose industries such as clothing, footwear and light assemblies, which import the raw materials in order to make use of low cost (but productive) labor to make or assemble goods for export, typically have a high imported raw material share in costs and are expected to be attracted to export-dedicated platforms.

### 3. Structure of Export Platforms in Kenya

#### *Export Compensation*

Kenya’s Customs and Excise legislation has always had provision for drawing back the import duty content of manufactured exports. These provisions were never effectively utilized, in part because of the demanding administrative requirements of setting up a duty drawback program. Instead, an alternative program providing for a flat rate compensation for selected manufactured exports was introduced under the Local Manufactures (Export Compensation) Act in 1974.

The main attraction of this program was its administrative simplicity. Any exporter of eligible goods could claim export compensation payment based on the customs value of the export at the applicable compensation rate, which was typically set in the 10% to 20% range. For a period, a higher compensation rate was paid for incremental exports to further encourage export growth. Payments for eligible types of manufactured exports were made against customs, shipping and banking documents showing that eligible goods had been exported and the foreign exchange earnings repatriated into Kenya. Eligible goods were generally manufactured goods expected to have a reasonably high domestic value added, but excluding all natural resources and agricultural produce.<sup>3</sup> Another attractive feature of an export compensation scheme was that it offset the import duty costs of both directly imported raw material and indirectly imported inputs including capital equipment and of productive assets. To keep the program simple, it offered one compensation rate for all eligible export products.

This simplicity formed a major critique of the program and a decision to replace it with a duty exemption scheme was adopted as part of the trade reform program in the late 1980s, and it was finally

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<sup>3</sup> Eligibility of manufactured goods for being scheduled for export compensation was based on the following criteria: 30 percent domestic value added; imported inputs used should be liable for at least 20 percent duty; the goods should not be subject to royalties, export taxes, international quotas or other forms of restrictions, and; goods should not be raw (unprocessed) materials or intermediate inputs which are high priority inputs in short supply locally or inputs on which value added can be substantially enhanced by further local processing.

phased out in September 1993, on several grounds. First, some types of exports were over compensated, while others were significantly under compensated, and the lowering of import duty rates particularly in the 1990s was resulting in a higher probability of over compensation for a higher share of exports. Second, the scheme benefitted a few large firms which, typically, accounted for less than 5% of total exports. In 1991 for instance, two firms accounted for over 50 percent of the compensation paid, five firms for over 60 percent, and ten firms for over 70 percent.<sup>4</sup> Third, the program had become embroiled in a major export fraud in 1992-93. Finally, its simple *ad valorem* payment structure, that is, no direct relationship between compensation and the import duties actually paid on inputs physically incorporated in the exports, made it fall into the class of prohibited subsidies which could be counter-vailed by an importing country under WTO/GATT rules.

### *Manufacturing Under Bond*

Manufacturing-under-bond (MUB) was established in 1988 under the structural adjustment policy regime. It provided for bonded factories that were allowed duty free import of plant, equipment, spares and raw materials to manufacture goods for export, an additional investment incentive in the form of favorable income tax treatment of capital expenditures, and following introduction of a value added tax started in 1990, imports by MUBs and their domestic input purchases were zero rated.

MUB plant and equipment qualify for 100% write-off against taxable profit in the year they are put into use. Other enterprises in Kenya are offered tax breaks on investment on the so called “split system” where a proportion of investment, presently 60% for most plant and equipment, is expensed immediately and the remainder receives the regular depreciation allowance applicable for the particular type of asset. Initially, the special incentive was limited to new factories, but this was later relaxed to allow bonded manufacturers the flexibility to locate in rented facilities and still get the 100% expensing on machinery and equipment purchases. The tax break is not transferable, that is, an enterprise leaving the scheme or selling the machinery and equipment is liable for income tax to the value of the difference between the standard investment allowance and the preferential rate.

Domestic sales of outputs or raw material require approval of the Commissioner of Customs and are subject to payment of all duties and taxes applicable to similar imports. Control of MUBs requires Customs to physically verify inventories of the imported raw materials, the manufactured products, waste and scrap material (as opposed to “off-site” accounting controls), which in turn requires the factories to meet physical specifications. There are no restrictions on location as Customs were generally able to provide officers to inspect the factory at desired locations. Even though sales into the domestic market are subject to the duties and taxes applicable to imports, they are discouraged given that the duty exempt importation of plant, machinery, equipment and spares and preferential capital investment allowance confer advantage over regular domestic factories.<sup>5</sup>

### *Export Processing Zones*

The EPZ scheme was established through the Export Processing Zones Act, passed in 1990. It provided a generous incentive package, tailored to attract “footloose” manufacturers: a corporate tax holiday for the first ten years of operation, and a guarantee that the rate would not exceed 25% for the next ten years (the rate was 42.5% at the time); duty and VAT waiver on imports of plant equipment and raw materials (except for motor vehicles, unless used exclusively in the zone, and motor vehicle spare parts);

<sup>4</sup> Bellhouse Mwangi Ernst &Young, *Export Compensation and Import Duty Remission Study*

<sup>5</sup> Two other cases of manufacturing under bond are allowed under the Customs legislation in Kenya. One is the refining of crude oil and the other is the assembly of motor vehicles from kits. Where refined oil products or assembled vehicles are exported, these facilities effectively operate as MUBs. All sales into the domestic market are treated as dutiable imports.

exemption from foreign exchange controls, and expedited licensing at reduced business license fees. They are exempt from rent and tenancy controls, but no waivers from labor legislation. The exemption from foreign exchange controls would have been a significant attraction to set up EPZ enterprises, especially to attract foreign direct investment, but this changed with the liberalization of the foreign exchange markets in 1993-94. The other incentives have also been eroded over time. For example, the company tax rate has dropped through the 1990s reaching 30% in 2000.

EPZs are gazetted as special purpose corporations that can only do business in a designated EPZ location, which may be a single factory or a unit in an EPZ industrial park, supervised by the EPZ Authority, which also licenses them. Although targeted primarily at new foreign direct investment, Kenyan companies are allowed to establish EPZ subsidiaries, but cannot do part of its business inside an EPZ and part outside. Specific provision were also introduced into the Income Tax Act to prevent "tax straddling" between EPZ enterprises and related domestic companies through transfer pricing, such as a domestic company providing administrative services to a related EPZ company charging the services against the taxable income of the domestic company, or shifting taxable income into the tax free EPZ company by under-invoicing for services provided to it.

For Customs purposes an EPZ is regarded as being outside the customs territory. Sales from Kenyan businesses into an EPZ are treated as exports, and sales from the EPZ to Kenyan businesses are treated as imports for duty and VAT purposes. There is no limit on sales into the domestic market, but such sales would be regarded as imports subject to regular duties and taxes on imports. The duty exemption on capital equipment and the income incentives, however, give the EPZ company an advantage over other domestic producers supplying the local market. To discourage abuse of the apparent unlimited access to domestic sales, a provision exists for an optional additional duty of 5% on domestic sales of a specified EPZ company. An EPZ being regarded as outside of the customs territory can result in importing countries not recognizing the export as being of Kenyan origin for the purposes of trade preferences. Notably, EPZ exports do not qualify for preferential tariff rates under the rules of origin of the COMESA. COMESA tariff rates are currently 80% to 90% below the rates levied on imports from outside COMESA countries.

Stacked up against these incentives is a range of potential additional costs that may discourage entry into an EPZ. First, the requirement of export dedication exposes the EPZ firm to risk of excess capacity. Second, unless a firm incurs the bureaucratic costs of convincing the EPZ Authority to gazette its chosen location (which then restricts its future uses of the site as it is difficult to remove EPZ status once awarded), EPZ status restricts choice of locations, which can influence transportation costs, access to labor, rental cost of buildings, and cost of utilities. Third, involvement in an EPZ may expose the business activities of a firm both inside and outside the EPZ to greater scrutiny by tax officials and also to program compliance costs. Entry into an EPZ essentially puts a business in the formal sector, while some business such as light or "sweat shop" manufacturing may be able to operate at lower costs in the informal sector.

### *Duty and VAT Exemption Scheme*

This program was introduced in 1990 to provide export incentives to manufacturers primarily serving the domestic market. The program became fully operational by 1993. It offers duty and VAT exemptions to imported inputs physically incorporated in the exported product or consumed in the production of the export.<sup>6</sup> It excludes exemptions for plant, equipment and machinery. The program is administered by the Export Promotion Programmes Office (EPPPO) in the Ministry of Finance, and is often referred to as the "EPPPO" program.

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<sup>6</sup> Consumables include items such as testing chemicals and cleaning materials, but exclude lubricants and fuels, except for coal, coke and residual fuel oils.

Initially, any business with confirmed export orders or with a documented track record of exports could apply for duty free imports to meet these actual or expected export orders. Firms are required to provide input-output ratios to support their applications. They are required to reconcile the duty exempt imports with goods produced and exported (including sales to EPZ enterprises or MUB export businesses) after exportation or within 9 months of exemption approval, or otherwise re-export, apply for a rollover of the exemption or pay the applicable taxes. Exemptions are granted against a performance bond (guarantee by a bank or insurance company) to the value of the duties exempted. The bond is cancelled upon verification of the reconciliation reports.

Over time, the program has been enhanced to improve its effectiveness in reducing negative protection of domestic manufacturers. To remove the bias against using domestic inputs, and also to improve backward linkages, indirect exporters can apply for duty exemptions on imports used to produce inputs for direct exporters. Such backward linkages can go back two stages of production. For example, a paper board manufacturer will get import exemptions for boards supplied to a packaging converter who then supplies packaging to a direct exporter. Exemptions for manufacturers of goods that can regularly be imported duty free (primarily pharmaceuticals, agricultural inputs and books) as well as domestic suppliers of certain organizations with duty free import privileges (such as the armed forces, aid-funded projects, international airlines, etc ) were consolidated into the program. And since 1996, general provisions were added to the Income Tax Act that allow businesses undertaking large investment projects of over \$5 million within two years (whether or not for export) to apply to have the import duties on capital equipment credited against future income taxes earned from the investment project.

#### 4. Actual Usage and Performance of Export Platforms in Kenya

##### *Manufacturing Under Bond*

After a slow start MUBs, proved reasonably attractive in the early 1990s particularly, as discussed below, during the period of a weak shilling and low real wage costs around 1993 and 1994. These conditions made contract manufacturing, particularly of clothing and household textiles, more competitive internationally. At its peak in 1993, there were over 70 bonded manufacturers, all but a handful of them garment manufacturers producing cotton garments for the US market. The program was set back by the reduction of Kenya's garment quota by the US trade authorities in 1994, and the subsequent appreciation of the exchange rate and wage rate. By 1997, all but 10 of the bonded manufacturers had closed down.

##### *Export Processing Zones*

EPZ infrastructure development has considerably outpaced EPZ enterprise investment. As at end 1997, there were 11 gazetted industrial park EPZs and 5 single enterprise EPZs. There were 5 developed parks with a combined capacity of 70 godowns, as compared to only 22 operational enterprises. See Table 1. All but one of the parks are privately owned and developed. The Government-owned park, also the largest, was funded by the World Bank and is located on a 340 hectare site in Athi River, a small industrial town 25 Km outside of Nairobi, and is managed by the EPZ Authority. Presently, it has 12 built-up units (9 occupied) and vacant lots available on for leasing to enterprises or other park developers. Space rental rates in the EPZ industrial parks in Nairobi range from US\$ 2.80 to 3.50 per square foot per year, as compared to US\$ 2.00 for industrial space in the open market.

Most of the EPZs (11 out of 16) were licensed by 1993, and all but one of those licensed after 1992 are either undeveloped or have no occupants. As pointed out above for MUBs exchange rate and wage conditions were more favorable for exporting through 1993. In addition, a major attraction of EPZs

prior to foreign exchange liberalization during 1993-94, was the allowance that EPZ operate freely in foreign exchange at a time when it commanded a market premium.

Unlike MUB enterprises which have been almost exclusively garment manufacturers, EPZ firms are engaged in a broad range of activities, although garment manufacture is still the dominant activity (8 out of 25 firms). Other activities include agro-processing, pharmaceuticals, paper and printing, computer assembly, software development, and automotive engineering. In addition, some potential garment manufacturers who had been licensed did not commence operations as a result of the imposition of quota by the US trade authorities in 1994. In terms of origin of investment, 12 out of the 22 EPZ enterprises operating in 1997 were fully foreign owned, and another two with a nominal one percent domestic shareholding. There were only four 100 percent domestically owned enterprises. The UK is the dominant source of foreign investment into the EPZs, accounting for close to 60% of the total capital investment in EPZ enterprises. See Table 2.

EPZ's contribution to exports and employment remains far below initial expectations. See Table 3. Exports reached US\$ 23 million in 1997, accounting for 3.5% of total manufactured exports. In growth terms, 25% average annual growth rate of EPZ exports in the 1993-1997 period was just marginally higher than the overall manufacturing exports 22% growth rate. Similarly in employment, EPZ firms employed 2,855 workers in 1997, accounting for barely over 1 percent of total manufacturing employment. Excluding 1994, when employment increased by 65%, EPZ employment growth, at 3%, was about half the total manufacturing employment growth rate. Domestic expenditures, including labor costs, on average account for 20% of turnover. Raw material imports averaged 64% of turnover over 1993-97, but declined 49% in 1997 showing increased domestic valued contribution from EPZ enterprises. Domestic sales also dropped from 53% in 1993 to 25% in 1997 showing a greater dedication of EPZ activity to exports.

Factors cited for the poor investor response to EPZ incentives include ineligibility of EPZ firms for preferential treatment in the regional market, which is the main market for Kenyan manufactures. Under COMESA rules of origin, EPZ goods are treated as foreign goods. Infrastructure deficiencies, particularly transport infrastructure and unreliable power and water supply is another factor cited. Manufacturing firms responding to a 1997 survey reported estimated production losses due to frequent power and water outages at Ksh 85 million (US\$ 1.4 million) or 4.6% of turnover on average. The effects of other structural and macroeconomic environmental factors will be discussed below.

**Table 1: Development and Utilization of EPZ Infrastructure**

EPZ name	Licence date	Location	Ownership	Capacity	Occupancy
Sameer Industrial Park	1990	Nairobi	private	12 units	9
Athi River EPZ	1990	Athi River	public	12 units, 62 vacant lots	9
E.A. Molasses EPZ Ltd	1992	Nairobi	private	n/a	2
Thomas De La Rue EPZ Ltd	1992	Nairobi	private	Single status	1
Birch Investments EPZ Ltd	1992	Mombasa	private	Single status	1
Anicit EPZ Ltd	1992	Nakuru	private	Single status	Not operational
Transfleet EPZ Ltd	1993	Mombasa	private	15 units	0
Mugoya EPZ Ltd	1993	Nairobi	private	Under development	-
Kigorani EPZ Ltd	1993	Mombasa	private	15 units	0
Kwa Jomvu EPZ Ltd	1993	Mombasa	private	Not operational	-
Real Industrial Park	1993	Nairobi	private	Not operational	-
Bianca EPZ Ltd	1994	Nairobi	private	Single status	Not operational
Rafiki Industrial Park	1995	Nairobi	private	7 units	3
Coast Industrail Park	1995	Mombasa	private	9 units	0
Kipevu EPZ Ltd	1996	Mombasa	private	Not operational	-
Golden Sun EPZ Ltd	1997	Malindi	private	Single status	Under development
Equitea EPZ Ltd	1998	Kilifi	private	Single status	Under development

Source: Export Processing Zone Authority

**Table 2: Ownership of EPZ Enterprises 1993-98**

Nationality of Investors	Share of ownership				Equity investment (US\$ million)	% of total EPZ investment
	100%	Majority	Minority	Equal		
United Kingdom	4	2	1	0	53.1	68.4
Domestic	4	2	5	1	19.4	25.0
Other	6	3	1	1	5.1	6.6
Total					77.6	100.0

Source: Export Processing Zone Authority

**Table 3. Performance of EPZ Enterprises 1993-1998**

	1993	1994	1995	1996	1997	1998
Investment (cumulative over years) (US\$ m)	44.5	52.1	87.9	96.4	101.0	
Imports (machinery) (US\$ m)	22.5	2.4	2.4	1.8	0.1	
Imports (raw materials) (US\$ m)	22.1	10.9	16.3	15.2	15.0	
Exports (US\$ m)	10.4	9.0	14.2	19.5	22.8	
Domestic Sales (US\$ m)	11.6	7.8	12.3	8.9	7.7	
Domestic Purchases (US\$ m)	4.9	3.4	4.2	5.3	6.5	
Employment	1,594	2,632	2,718	2,950	2,855	3,645
Number of enterprises	13	15	19	18	22	22

Source: Export Processing Zone Authority

### *Duty and VAT Exemption (EPPO) Program*

Companies utilizing the EPPO program accounted for 35% of total merchandise exports over the 1993-98 period. Processed goods accounted for 53% of total exports over the period, which translates to the program being utilized for over two-thirds of eligible exports. Analysis of application and reconciliation administrative data against the actual export data from Customs suggests that direct exporters using the program utilized it for 60% to 70% of their exports on average – over 50% of the eligible processed and packaged exports, and over 75% of exports of manufactures. Table 4, showing the build up activity by the number of applications, indicates that the program plateau-ed in 1994. Direct export applications fluctuated within the 1,100 to 1,300 range thereafter. Activity declined in 1998 in line with the decline in exports in that year. In addition, after 1994 the average duty rate on many intermediate goods and other raw materials dropped from around 25% to rates of 15% or lower. This lowered the net gain from participating in EPPO measured relative to the export values from an average of 3% to 4% down to 2% to 3%. Hence, some firms could have dropped out if the other compliance costs of participating exceeded this lower duty gain.

**Table 4: Application activity under EPPO, 1991-1998**

Year	Direct Exporters	Indirect Exporters	Other duty exempt	No. of Companies
1991	39			n/a
1992	113			n/a
1993	618		305	n/a
1994	1,165	15	779	191
1995	1,120	100	575	169
1996	1,113	191	100	206
1997	1,311	251	197	200
1998	1,186	198	107	168

*Source: EPPO, Ministry of Finance*

Some 431 different direct exporters had used the program by 1998, as had 45 indirect exporters and 48 companies for the production of other duty exempt goods (Table 5.) Typically, on an annual basis, direct exporters have been getting about Ksh 5 billion of imports duty exempt through EPPO to produce about Ksh 28 billion in exports; indirect exports have been importing about Ksh 1.5 billion duty exempt leading to some Ksh 5 billion in exports; and essential goods suppliers have been getting Ksh 0.5 billion in duty exempt imports to produce about Ksh 3.7 billion in duty-free products. (Total merchandise exports averaged about Ksh 100 billion a year over 1993-98.) However, utilization of EPPO is highly concentrated amongst the large exporters. The top 10 exporters using EPPO account for about 50%, and the top 20 for 60% to 70% of all the exports by direct exporters in the program. These top 20 exporters qualify for 40% to 50% of the duty exempt imports and duty remissions under EPPO (Table 6.) The direct exporters utilizing the program cover more or less the entire spectrum of Kenya's processed exports--processed foodstuffs (canned fruits, vegetables and juices, vegetable oils, biscuits), horticultural products, beverages, cigarettes, footwear, clothing and textiles, metal and wood products, cleaning products, cement, salt, and soda ash. The major indirect exports supported by the program are packaging materials. Over 1993-98, however, over 50% of the exports by firms using EPPO were directed at COMESA countries. This means that the discussion of the future role of export platforms within a free trade area such as COMESA, which was broached above, has major significance for Kenyan regional customs and trade policy. A cancellation of the use of export platforms within COMESA or the East African Co-operation would have significant impacts on exporters, import duty revenues and the volume of export business supported by EPPO.

**Table 5: Companies using duty/VAT exemption facility in 1991-98**

Type of Use	No. of Companies
Exporters	476
Direct exporters	431
Indirect exporters	45
Duty free goods manufacturers	48
Pharmaceuticals	21
Agricultural chemicals	4
Agricultural equipment	8
Book publishers	5
Suppliers to aid-funded projects	5
Suppliers to armed forces	4
Suppliers to international airlines	1

Source: EPPO, Ministry of Finance

**Table 6. Utilization of EPPO Scheme (% share)**

	1994	1995	1996	1997	1998
<b>By Import Value (CIF)</b>					
Top 10 firms	22	20	25	27	23
Top 20 firms	42	39	46	51	43
<b>By Duty Remission Value</b>					
Top 10 firms	26	27	31	27	34
Top 20 firms	41	49	52	51	51

Source: EPPO, Ministry of Finance

## 5. Macroeconomic Policy Factors

### *Export Trends*

Figure 1 gives the domestic export performance for Kenya for 1985 to 1998 by various measures. The dramatic change in exports that arose in 1993 shows up whether exports are measured as an export quantity index, a share of GDP, real US\$ value or real K£ value of exports. Outside of the small coffee boom of 1986, exports showed only modest real growth through 1992. They recovered dramatically from 1993, peaked in 1996, and fell back substantially in 1997 and 1998. In evaluating the role of export platforms, it is necessary to review this recovery against changes in the macroeconomic policy environment. This is followed by a discussion of the evolution of composition and direction of exports over the period. The usage of export platforms is then revisited against this background and some conclusions drawn about their significance and future potential.

### *Trade liberalization*

Trade liberalization started with a conversion of quantitative restrictions to tariffs equivalents in 1987-89 which, initially, raised the simple average tariff rate from 40% to 46 percent<sup>7</sup>. The government embarked on a phased tariff reductions (particularly in the high-rate bands) and rationalization of the tariff bands in 1990. By 1997/98, the simple average tariff rate had been reduced to 16.2%, and the trade weighted tariff rate to 12.8% , down from 25.6%. The number of tariff bands (including duty free) were reduced from 15 in 1990/91 to 4 in 1997/98 and the top regular tariff rate from 100% to 25% over the same period. The duty rates on most capital equipment has come down to 5% from the

<sup>7</sup> Average of all *ad valorem* tariffs in customs tariff schedule. Tariffs are weighed by number of tariff items recognized in tariff schedule.

15% to 25% range, and most raw materials and intermediate inputs to the 5%-15% range, down from 25% or higher. However, the single most significant change in the trade policy regime came in May 1993 with the abolition of import licencing requirements and, more importantly, foreign exchange controls. Over 1993-94, all current account and virtually all capital account restrictions were lifted. The impact was immediately evident in the trade flows; imports jumped by some 7% of GDP after averaging 24% from 1981 through 1992 to over 30% of GDP, and as already discussed above, exports surged by about 7% of GDP as well.

The trade liberalization process was interrupted by the onset of a stabilization crisis in 1997, following collapse of an IMF program, election-spending-related budgetary crisis, and exchange rate instability accompanying the Asian crisis. Stability was restored by raising interest rates which in turn attracted short-term capital inflows that led to a substantial appreciation of the Kenya shilling throughout 1997 and 1998. A range of suspended duties were imposed starting in mid-1997, raising the simple average tariff rising to 17.8% and the trade weighted average to 14% by mid-1999. Interest rates finally moderated in early 1999 leading to a sharp 12% real decline in the strength of the Kenya shilling, but the temporary protection has not been removed. And as tariff rates have declined, particularly from 1994/95 onwards, the net subsidy provided by export platforms, that is, tax benefit less administrative compliance and other costs of using an export platform, have declined.

### *Real exchange rate*

The real (inflation adjusted) exchange rate is a critical variable in international trade. This is clearly borne out by Kenya's recent experience. Figure 2 shows the evolution of the real exchange rate from 1985, using the Ksh/US\$ exchange rate with both currencies adjusted to their 1996 values by their respective consumer price indices. After strengthening in 1986 through 1998 in response to a minor coffee boom, crawling peg adjustments to the shilling gradually reduced its real value through to the early 1990s as part of the export promotion strategy. While there was some growth in exports through 1992, it was only with the liberalization of foreign exchange markets starting in 1993 that boosted trade significantly. In addition, a monetary overhang associated with election spending in the second half of 1992 contributed to the sharp depreciation of the shilling once the foreign exchange market was liberalized. This trend was reversed by a tight monetary stance adopted thereafter to bring inflation under control causing the shilling to appreciate throughout 1995. The suspension of the IMF program in mid-1997 resulted in a sharp rise in interest rates. In addition, the next electoral cycle in late 1997 triggered another expenditure boom followed by a tight monetary stance and high interest rate regime that strengthened the real exchange rate beyond its 1986-88 levels. The loss of competitiveness due to this real exchange rate appreciation, alongside sharp devaluations in Asia, South America and southern Africa, is evident in the worsening export performance after 1996 as shown in Fig 1.

### *Labor costs and productivity*

Data on employment and wages by export facility are not available, but given the dominance of the duty exemption program over the dedicated facilities (MUB and EPZ), the latter are unlikely to have a significance impact on the labor market, hence wage and productivity for the formal manufacturing sector are analyzed as a proxy for export platform conditions. Table 7 shows the employment, productivity and wage rate data for the manufacturing sector for 1990-98. Employment and wage rate data for all sectors are also given to show that the manufacturing sector experience was similar to the overall experience over the 1990s. That said, a large proportion of Kenya's urban labor force is engaged in informal "sweat shop type" enterprises (the so called "jua kali" sector), where earnings are considerably lower than formal sector wages, and lower still in the rural areas, hence these data present only a partial picture of the labor market. Even within the formal sector, there are large wage differentials between unionisable workers (those on "permanent" employment) and more temporary or contract employees. Typically, the former earn twice the latter for comparable work.

**Table 7. Labor Productivity and Wage Costs in Kenyan Manufacturing 1990-1998**

	1990	1991	1992	1993	1994	1995	1996	1997	1998
<b>Manufacturing Sector</b>									
Employment growth (%)	2.7	0.6	0.7	1.7	2.0	3.7	2.8	1.9	1.1
Output growth (quantity index) (%)	5.3	2.8	1.3	1.8	1.9	3.8	3.2	1.9	1.4
Implicit labor productivity growth(%)	2.6	2.2	0.5	0.1	-0.1	0.2	0.4	0	0.3
Wage cost/Gross output (%)	3.9	4.1	3.5	3.1	3.0	3.3	3.3	3.5	3.7
Wage cost/Value added (%)	33.1	35.7	32.1	32.2	32.3	35.4	37.5	40.5	39.4
Real wage growth (%)	-2.0	-9.4	-12.8	-22.3	-8.7	24.7	11.7	8.9	14.5
Average real wage rate (1996 Ksh p.m.)	9,717	8,809	7,680	5,967	5,450	6,795	7,589	8,260	9,457
Average nominal wage (US\$ p.m.)	133	120	114	70	87	121	133	156	186
Average real wage rate (1996 US\$ p.m.)	161	139	129	76	93	125	133	153	178
<b>Economy Aggregates</b>									
Employment growth (%)	3.0	2.3	1.4	0.9	2.0	3.4	4.0	1.8	1.1
Real wage growth (%)	-5.9	-8.3	-10.9	-22.1	-8.3	19.8	11.7	8.5	17.3

Source: Central Bureau of Statistics, *Economic Survey, various issues*

In aggregate, real wage movements in the 1990s have been dominated by effects of inflation and exchange rate volatility, while output movements reflect capacity utilization driven by domestic market conditions. In other words, there is no evidence of systematic export-led productivity growth. While real wage rates were falling through 1993, the exchange rate was also weakening resulting in declining US dollar costs of labor. These made for increasingly attractive conditions for exports. See Figure 2. From 1994 onwards, however, the real shilling wage rate grew strongly, rising by 74% over 1994-98. The combination of increasing real wage rates and a stable nominal shilling (it depreciated nominally between 1994 and 1998 by less than 7%) resulted in the nominal US dollar cost of manufacturing labor jumping by 114% between 1994 and 1998 (or 92% in real US dollar terms), while the real exchange rate appreciated and labor productivity remained more or less stagnant. In 1997 and 1998, non-fuel commodity prices in international trade dropped by 3.3% and 14.8%; over 1994-98, these world prices dropped by 12%. These conditions can be interpreted in terms of the final term of equation (H) above which gives the cost of non-tradeables (essentially labor) in terms of world prices, namely  $(w/E)(L/Q)/p^*$ . The real wage rate ( $w$ ) in shillings increased while the exchange rate ( $E$ ) strengthened giving a major increase in the US dollar cost of labor ( $w/E$ ). Little or no improvement is noted in labor productivity ( $Q/L$ ) and real international prices ( $p^*$ ) fell in 1997 and 1998 with the Asian crisis. Overall the cost of labor in Kenyan manufacturing increased by 118% in terms of international trade prices from 1994 to 1998. This combination of adverse conditions clearly contributed to the decline in exports that set in 1997 and continued in 1998. It is also important to note that these conditions are particularly deleterious for labor-intensive exports.

### *Regional market developments*

Kenya, Uganda and Tanzania established a common market, the East African Community, in 1966, shortly after they gained independence, but ideological tension (after Tanzania adopted a socialist manifesto in 1969) and political instability in Uganda undermined the integration effort and the Community was officially dissolved in 1977. The decline of Kenya's export performance from the mid-1970s to the mid-1980s is attributable to a large degree to the collapse of the Community, and the subsequent deterioration of the Ugandan and Tanzanian economies, hitherto the principal markets for Kenya's manufactures. By the late 1980s, the Ugandan and Tanzanian economies were on the road to recovery, and by 1993 formal arrangements to re-establish East African common market were underway. At the same time, internal tariffs were lowered as part of an integration initiative in the larger Eastern and Central Africa region (COMESA). The East African Co-operation initiative is also aiming

for zero internal tariffs by mid 2000. In effect, the 1990s have offered Kenya increasingly attractive regional export opportunities as the Tanzanian and especially the Ugandan economies grew strongly, while Kenya still had an underutilized manufacturing capacity.

*Infrastructure and other economic environmental conditions*

Inadequate economic infrastructure, including roads, railways, ports, telecommunication services, electricity and water, has become a persistent, and increasingly binding constraint in Kenya. Relations between the Kenya government and aid agencies have soured over the last decade and as a result, there has been inadequate new public investment in economic infrastructure. Overall public sector gross fixed capital formation dropped from 10% in 1990 to 6.5% of GDP in 1998. Manufacturers who responded to a recent survey reported average losses close to US\$ 2 million per year associated with electricity and water shortages.<sup>8</sup> Additionally, general law enforcement, hence physical security of people and property, and judicial support for commercial contracts have worsened over time. All these factors tend to raise the costs of doing business in Kenya which adversely affect export competitiveness.<sup>9</sup>

*Foreign Direct Investment*

Foreign direct investment (FDI) is of particular interest for export platforms, particularly the export-dedicated platforms such as MUB and EPZs, as they usually target FDI, especially the so called “foot-loose” industries. Despite a strong international presence in virtually all the sectors of the Kenyan economy, there is remarkably little information on FDI activity in Kenya. Systematic monitoring of FDI began in 1988, when the Government established the Investment Promotion Center (IPC) to promote inward investment. By the end 1997, the IPC had approved 477 FDI projects worth US\$ 600 million in capital investment. Not all FDI investment go through the IPC, however, and the IPC also does not monitor the investors it facilitates beyond the approval stage. The IPC estimates that it facilitates about one half of new FDI, and only a third or so of the projects it approves translate into actual investments. These estimates suggest cumulative inward FDI over this period (1989-97) at about US\$ 400 million or US\$ 30 million per year on average, or just under 4 percent of annual gross private investment.<sup>10</sup> This is consistent with the very low investment activity in EPZs and MUB export platforms discussed above.

The origin of FDI inflows to Kenya is fairly diversified, but traditionally the UK has been the single most significant origin of FDI. UK firms accounted for one out of five of new foreign investment projects facilitated by the IPC in the 1989-97 period, and 23 percent in value terms. South African trade and investment, however, has grown dramatically since the lifting of economic sanctions in 1991, and current trends indicate that it could soon become the single largest origin of FDI. South Africa has already displaced the U.K. as the principal origin of imports. South African firms, however, which have invested in Kenya tend to be targeting the domestic market as opposed to exporting out of Kenya.

**6. Composition and Direction of Exports from Kenya**

As discussed earlier, export platforms were put in place in Kenya in the late 1980s (MUB) and early 1990s (EPZs and duty/VAT exemption program) but it was only after the lifting of trade licensing and,

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<sup>8</sup> Comparative Advantage, Competitiveness and Supply Capacity in Kenya’s Manufacturing Sector. Draft Report by Peter Hopcraft for the Export Promotion Council), September 1998.

<sup>9</sup> Surveys such as *The African Competitiveness Report 1998*, World Economic Forum, Geneva 1998 also show the inadequacy of economic infrastructure in Kenya, lowering its international competitiveness.

<sup>10</sup> World Bank data on Foreign Direct Investment in Kenya indicates an annual average investment of \$34 million in the 1980s and \$19 million over 1990-96.

more importantly, foreign exchange controls in 1993 through 1994 that exports grew significantly. As the analysis of the direction and composition that follows will show, this growth has been driven by regional market developments, in other words, export platforms have not enabled Kenya to gain entry into the industrialized country markets for labor-intensive manufactures.

Table 8 shows that exports in US dollar terms grew in 1993-95 by 35% over their 1990-92 level, and in 1996-98 by 67% over their 1990-92 level. This masks vast differences in the pattern of export growth. Exports to COMESA countries grew by 179% by 1993-95 and 290% by 1996-98 compared to the base period. This pulled up the COMESA share of exports from 14.6% to 34%. Non-COMESA exports only grew by 10% by 1993-95 and 29% 1996-98. Exports to Uganda and Tanzania showed the highest growths of 320% and 549%, respectively, by 1996-98 compared to the base period. This sharp increase pulled their share of Kenyan exports up from 9% to 27%. Hence, there was a major shift in the direction of trade following trade liberalization.

Looking behind the broad categories of exports shows that tea and coffee maintained their share of exports during this period of rapid export growth. They started the period in 1990 at 45% of exports, and at 74% of primary exports, and ended it in 1998 at 41% of exports, and at 81% of primary exports. In between, they fluctuated between a low of 31% of exports in 1992 and a high of 41% in 1990, averaging 38% of exports, and 78% of primary exports.

Processed and manufactured exports basically represent the range of goods produced for the Kenyan market. These products include cigarettes, beer, cement, paper products, refined petroleum products, corrugated iron sheeting and other rolled metal products, pharmaceuticals, vegetable oil and processed fruit and vegetable products, flours of wheat and maize, processed sugar and other confectionery products, and processed leather. Hence, exports into the region have been an extension and expansion of production for the Kenyan market. Many are capital intensive (cement, oil and paper products) or processed agricultural products. A very small share have been in the more common labor-intensive products that are normally taken to characterize manufactures of developing country such as Indonesia or the Philippines – footwear, clothing and assembled electronics and other household goods. Textiles and clothing exports increased, but only from 1.3% of exports in 1990-92 to 4.9% in 1993-95, and then fell back to 2.1% again in 1996-98. As shown in Section 4, the textile and clothing exports received a boost through 1993 when the Kenya shilling and wage rate conditions were the most favorable to exports and the foreign exchange markets were being decontrolled. Subsequently, however, the Kenya shilling strengthen again in real terms and labor costs in US dollar terms rose sharply. These trends reversed the competitiveness of Kenyan exports dramatically. Over 1996 through 1998, Kenyan exports declined by 5.8% in US dollar terms.

**Table 8: Destination of Kenyan Exports 1990-98**

<b>Destination</b>	<b>1990-92</b>	<b>1993-95</b>	<b>1996-98</b>
<b>Uganda</b>			
Value, annual average(US\$ m)	69	199	290
Share (%)	5.9	12.6	14.9
<i>Growth</i> (%)		188	320
<b>Tanzania</b>			
Value, annual average(US\$ m)	36	157	235
Share (%)	3.1	10	12
Growth(%)		335	549
<b>Other COMESA</b>			
Value, annual average(US\$ m)	65	120	139
Share (%)	5.6	7.6	7.1
<i>Growth</i> (%)		84	113
<b>All COMESA</b>			
Value, annual average(US\$ m)	170	476	664
Share (%)	14.6	30.2	34
Growth(%)		179	290
<b>Non-COMESA</b>			
Value, annual average(US\$ m)	995	1,098	1,268
Share (%)	85.4	69.8	66
Growth(%)		10	29
<b>Total</b>			
Value, annual average(US\$ m)	1,165	1,574	1,950
Share(%)	100	100	100
Growth(%)		35	67

*Source: Central Bureau of Statistics, Economic Survey, various issues; Ministry of Finance customs data*

When this is decomposed, exports to COMESA countries dropped by 9.3%, while those to non-COMESA countries dropped by only 3.7%. Exports of primary goods rose by 1.2%, while exports of processed and manufactured goods fell by 11.9%. Clearly, the macroeconomic conditions in 1997 and 1998 made Kenyan manufactured goods less competitive in the region which would have dampened any new interest in using export platforms in Kenya.

Table 10 shows the distribution of exports over 1993-98 across export platforms in aggregate and by SITC classification. The direction and pattern of Kenyan exports is consistent with the overall utilization of the various export platforms in Kenya. The EPPO program accounted for 35 percent of total Kenyan exports between 1993 and 1998 as compared to a combined share of less than 2 percent MUB and EPZ. The predominance of the EPPO duty/VAT remission facility reflects the fact that Kenya has not attracted much new investment over the last decade and, in particular, little investment (domestic or foreign) in the traditional footloose labor-intensive industries primarily to supply external markets. The program is a flexible program best suited to export business that is an extension or expansion of the supply for the domestic market, while the MUB and EPZ programs are targeted at manufacturing dedicated to exports. The main source of processed/manufactured export growth has been from utilizing existing capacity to exploit the regional market, which (a) consumes similar goods and (b) preferential access under the Common Market for Eastern and Southern Africa.

The main conclusion to be drawn from this analysis is that export platforms that are primarily designed for supporting dedicated export manufacturing (EPZ and MUBs) are much less attractive than more flexible structures such as the EPPO duty exemption program that can support regional trade in the

same goods that are produced for the domestic market. The duty exemption program has been extensively used by the major local manufacturing and processing companies (beer, cigarettes, cement, paper, corrugated iron sheeting, vegetable cooking oils, soaps, etc). This contrasts dramatically with the high utilization of EPZs in a country like the Philippines which specializes in the production of electronic goods for export to the world at large.

**Table 9: Composition and Destination of Kenyan Exports 1990-98**

Destination/Composition	1990-92	1993-95	1996-98
<b>COMESA, value (US\$m per annum)</b>			
Primary	9	17	30
Processed/Manufactured	161	459	634
All exports	170	476	664
<b>COMESA, composition (%)</b>			
Primary	5.5	3.6	4.5
Processed/Manufactured	94.5	96.4	95.5
All exports	100	100	100
<b>COMESA, growth contribution(%)</b>			
Primary		4.6	6
Processed/Manufactured		122.3	106.1
All exports		74.7	62.9
<b>Non-COMESA, value (US\$m per annum)</b>			
Primary	571	728	889
Processed/Manufactured	424	370	397
All exports	995	1098	1286
<b>Non-COMESA, composition (%)</b>			
Primary	57.4	66.3	69.1
Processed/Manufactured	42.6	33.7	30.9
All exports	100	100	100
<b>Non-COMESA, growth contribution (%)</b>			
Primary		95.4	94
Processed/Manufactured		-22.3	-6.1
All exports		25.3	37.1
<b>TOTAL, value (US\$m per annum)</b>			
Primary	580	745	919
Processed/Manufactured	585	829	1031
All exports	1165	1574	1950
<b>TOTAL, composition(%)</b>			
Primary	49.8	47.4	47.1
Processed/Manufactured	50.2	52.6	52.9
All exports	100	100	100
<b>TOTAL, growth contribution (%)</b>			
Primary		40.4	43.2
Processed/Manufactured		59.6	56.8
All exports		100	100

*Source: Central Bureau of Statistics, Economic Surveys, various issues; Ministry of Finance customs data*

**Table 10. Export Composition by Export Platform, 1993- 1998**

SITC Classification	Share of exports by export platform (%)				Share of Total Exports
	EPP0	MUB	EPZ	No platform	
0. Food & live animals	22.73	0.64	0.01	76.63	51.79
1. Beverages & tobacco	70.64	0.00	0.00	29.36	2.51
2. Crude materials, inedible	30.49	0.63	0	68.87	9.43
3. Mineral fuels	30.22	0.04	0.00	69.74	7.38
4. Animal vegetables & fats	59.87	0.01	0	40.13	1.73
5. Chemicals	40.83	0.47	0.13	58.57	6.31
6. Manufactured goods	68.66	4.14	0.11	27.1	14.18
7. Machinery & transport equip.	37.07	0.25	0.1	62.66	0.9
8. Misc. manufactures	51.33	2.56	0.01	46.1	5.4
9. Goods n.e.s	0.3	0	0.01	99.7	0.34
* SITC not found	16.13	0.13	0.13	83.62	0.04
<b>TOTAL</b>	<b>35.11</b>	<b>1.15</b>	<b>0.03</b>	<b>63.72</b>	<b>100.00</b>

Source: Ministry of Finance, Customs data

## 7. Conclusions

Kenya's export platforms have not generated the anticipated critical mass of "foot loose" labor-intensive export processing, despite the country having a relatively large skilled and semi-skilled industrial labor force that could be readily engaged to produce labor-intensive manufactures, notably garments and footwear, for the world market. First, the scope for building on the existing capacity to produce up-market consumer goods is limited by the low-income and small (by world standards) regional market (except perhaps for footwear and clothing, but even though the quality demands are substantially different). The situation is the same in most, if not all, Sub-Saharan African countries.

Second, attracting significant export dedicated investment requires the domestic investment environment to be extremely attractive; low cost and high productivity labor; dependable and cost effective transport, utilities and other infrastructure services; and comparatively low business risk. On a wide range of these competitive factors, many African economies are not sufficiently attractive. Evidently, tax incentive based export platforms have not been sufficient to overcome these constraints in Kenya. Given the small size of the local market, African countries will only attract export dedicated investment by offering a cost structure well below alternative locations. In the light of this outlook, the dedicated platforms, the EPZ program in particular, are unlikely to make a significant impact. The excess capacity in Kenya's public EPZ should be privatized to save costs, and parts of it deregistered and established as regular industrial parks. Even better would be to freeze approvals and phase out the existing users over time, while focusing on developing more flexible platforms and generalizing investment incentives.

Arguably, the more flexible EPP0 duty/VAT remission program has contributed to the remarkable growth of manufactured exports to the regional market. It is noted, however, that the East African Cooperation and COMESA trading partners have committed to phase out export incentives from regional trade within 5 years. In addition, tariff reduction has eroded the incentives from the program substantially. The attraction of the program will continue to diminish as further tariff reductions are implemented. However, given their flexibility, such programs will continue to have a role in (a) supporting direct and indirect exports outside the region, and (b) removing negative protection from the duty free or exempt goods produced for the local market. This flexibility arises from its ability to deal with busi-

nesses producing for both local and foreign markets simultaneously, from its lack of special income tax or other capital investment incentives, and because it is accessible to producers outside the strict limits of the manufacturing sector, such as mining and agriculture, which are typically excluded from export-dedicated platforms. In the Kenyan case, packaging is a critical input in fresh horticultural produce exports, and the duty/VAT remission program has played an important role in this leading export sector for both direct imports and locally produced packaging material.

The successful stint of the MUB platform suggests that there is scope for expansion of clothing and possibly footwear production for the international market, but only if market prices, productivity and other conditions are right. More careful further consideration will also be needed in the design of export platforms to ensure that they reduce restrictions on accessing the informal sector labor market such as through contracting out work. The tendency to use physical customs rather than accounting controls, as have characterized MUBs and EPZs to date, reduces the flexibility of exploiting the large informal sector labor market and achieving international cost-competitiveness in labor-intensive manufactures. A careful review of labor market laws and institutions is also needed to explain the growing gap between formal and informal sector wage rates. Given that it is formal sector companies that access export platforms, this wage gap trend does not augur well for export platforms becoming the spring board for job creation in labor-intensive manufactures in the medium term.

To get the macroeconomic conditions right will require a shift away from the high interest rates that have persisted since 1993. Over 1994-98, inflation-adjusted lending rates by commercial banks have generally been in the range of 15% to 30%. This will require a shift in government fiscal policy to budget surpluses to lower the current heavy domestic debt load. Lower interest rates will both encourage real private investment and discourage speculative foreign capital inflows that can allow a more competitive, export-promoting exchange rate. If the right macroeconomic environment (lower real interest rates, weaker exchange rate, and lower wages in US dollar terms) is combined with moves to increase the flexibility of export platforms and the labor markets, and efforts to strengthen economic infrastructure, then Kenya's export prospects in labor-intensive manufactures could brighten considerably.