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INSIDE

This paper looks at the agreement establishing a Framework for an Economic Partnership Agreement (FEPA) between the East African Community (EAC) Partner states, on one part, and the European Community (EC) and its member states, on the other. This framework was put in place to comply with a deadline imposed by the WTO that the two parties should bring their trade relations in compliance with the WTO rules. The main objective of this bulletin is to review the compatibility of the FEPA with the current WTO requirements and to analyse the implications for development and poverty in Kenya.

Economic Partnership Agreements, WTO Compatibility and Development for Kenya

By Mary Odongo

1. Introduction

Kenya has had a long-standing relationship with the European Union (EU) under the grouping of the Africa Caribbean and Pacific (ACP) states from the Lomé Conventions to the Cotonou Agreement. The establishment of the European Economic Community (EEC)[1] through the Treaty of Rome signed in 1957, and the contextualization of various treaties between the EU and ACP countries, through various conventions and treaties, formed the basis for the relationship. Table 1 provides a summary of the conventions and the years when they were signed between the EEC and the ACP countries.

Table 1: Conventions between the EEC/EU and the ACP Countries

Year	Convention
1963	Yaoundé I: Agreement between the EEC and 18 former francophone African colonies; providing the colonies with commercial advantages and financial aid.
1969	Yaoundé II: Renewal of Yaoundé I; including Kenya, Tanzania and Uganda; introducing preferential trade arrangements for developing countries and access to raw materials for the EEC.
1975	Lomé I: Convention including preferential trade agreements on most ACP products and the STABEX system for stabilization in agriculture export earnings as well as direct development aid.
1979	Lomé II: SYSMIN system providing stabilization aid to mining industries in ACP countries.
1984	Lomé III: Attention shift from industrial development towards food security and self-reliance.

1 The EEC became known as the EC in 1967, and the term the EU (European Union) was adopted in 1993

1990	Lomé IV: Focus on structural adjustment and crosscutting themes as a response to debt crises and famines.
1995	Lomé rev: Underlying the importance of human rights, democracy and good governance and regional cooperation; eighth European Development Fund (EDF) is not increased in real terms.
2000	Cotonou: Removal of most tariffs on imports from the ACP group with sugar and beef and veal to be covered by REPAs, and a new tariff-only banana regime to be phased in; shift towards participatory development paradigm.
2001	Everything but Arms (EBA): Immediate removal of all tariffs on all imports from LDCs except arms, with 3-stage removal of tariffs and quotas on sugar, rice and bananas.

Source: Bjørnskov (2001).

As the Lomé IV Convention came to an end, questions arose about the developmental benefits realized by the ACP countries as a result of this relationship with the EU, such as the market share of ACP countries, the size of the European Development Fund (EDF) as well as the persistent levels of poverty in the ACP regions. The trade preferences contained in the Lomé Conventions were more beneficial to the ACP countries than they were to other developing countries who were under the Generalized System of Preferences (GSP). The Lomé Conventions existed under a World Trade Organization (WTO) waiver but came to an end in 2000, bringing into focus a need to review ACP-EU cooperation.

The effect of the revisions and rethinking of ACP-EU cooperation led to the Cotonou Agreement, signed in June 2000. This agreement was, not only more extensive in scope than previous agreements between the EU and ACP countries, but also included a new WTO compatible trading arrangement. Chapter 1, Article 1 of the Cotonou Agreement set out the objectives of the partnership as:

> … *"Reducing and eventually eradicating poverty consistent with the objectives of sustainable development and the gradual integration of the ACP countries into the world economy."*

Chapter 2, Article 36 of the same agreement states that:

1. *"…the parties agree to conclude new World Trade Organization (WTO) compatible trading arrangements, removing, progressively, barriers to trade between them and enhancing cooperation in all areas relevant to trade.*

2. *The parties agree that the new trading arrangement shall be introduced gradually and recognize the need, therefore, for a preparatory period."*

These and other subsequent articles in the Cotonou Agreement formed the basis for the negotiations of the Economic Partnership Agreements (EPAs). Under the title heading 'Economic and Trade Cooperation', Chapter 2, Article 37 of the agreement reads… *"Economic partnership agreements shall be negotiated during the preparatory period which shall end by 31 December 2007 at the latest*". It also states that formal negotiations of the new trading arrangement shall enter into force by 1 January 2008, unless earlier dates are agreed between the Parties. This set the stage for negotiations on the EPAs which replaced the non-reciprocal trading arrangement which existed before with an arrangement that was WTO-compatible. Negotiations on the new EPA trading arrangement commenced in September 2002.

2. The EAC - Economic Partnership Agreement Negotiations

Kenya and her East African Community (EAC) partner states are currently negotiating a comprehensive Economic Partnership Agreement (EPA) with the objective of contributing towards sustainable development, the gradual integration of the EAC into the world economy and fostering the structural transformation of EAC, among other objectives. The negotiations pertaining to the comprehensive EPA began in January 2008 but due to a number of contentious issues in the interim EPA, progress had been slow. The negotiations towards a comprehensive EPA are currently ongoing with a major focus on the gains and losses that a comprehensive EPA might portend for the economies of the EAC partner states, and in particular Kenya. The EPA negotiations were to be concluded by 31 December 2007 in order to meet the deadline of the expiration of the Cotonou Partnership Agreement. In this way, the FEPA (Framework Economic Partnership Agreement) was initialed as a stand-in to the conclusion of the full EPA. This agreement has a requirement to be compatible with WTO rules as well as facilitating development in the ACP regions.

Of the five East African partner states, only Kenya is not categorized as a least developed country (LDC), while the other partner states are. The EAC is the only region in Africa where partner states have an identical liberalization schedule, and this is based on the EAC Common External Tariff (CET). The EAC countries

Table 2: Market Access under the EAC on Trade in Goods

Year	Value Liberalized (USD)	%age of Trade Liberalized	Value Excluded (USD)	EAC Exclusion	EC Liberalized	Substantially All Trade (SAT)
By 2010	1,725,753,302	64%	469,750,966	18%	100%	82%
Within 15 years	416,830,776	16%				90%
By 2033	65,507,218	2%				91%
Total Trade Liberalized by EAC	2,208,091,296	82%				91%
Total EAC Imports from EU	2,677,842,263					

Source: Agreement establishing a Framework for an Economic Partnership Agreement (FEPA) the EAC and the EU (2007).

signed the FEPA with the EC in order to be able to take advantage of the duty free quota free (DFQF) market access since the start of 2008. Table 2 gives details about the market access schedule under the EAC. It shows that, the EAC was to liberalize 64 per cent of products (raw materials and capital goods) by 1 January 2010 of what it imports from the EU. In the second phase, 16 per cent of import products (intermediate goods) from the EU was to be liberalized between 2015 and 2023. In the last phase, liberalization was to be at 2 per cent for finished products. The remaining 18 per cent included sensitive products which were excluded from liberalization. These items include, in part, agricultural products, chemicals, textiles and clothing, dairy, fish, meat, wines and spirits, etc. From the EU side, market access on EAC products imported into the EU would face DFQF market access for all products with the exception of arms and ammunition, sugar and rice. Under the EU Council Regulation, Article 3, import duties would be eliminated on all products of Chapters 1 to 97 but not of the Harmonized System originating in regions listed, except for Chapter 93, which detailed arms and ammunition where the Most Favoured Nation (MFN) principle would continue to apply.

3. WTO and EPA Compatibility: Contentious Issues

The subject of EPA-WTO compatibility has been high up on the agenda of the EPA negotiations, especially with the concerns emanating from the ACP countries with regard to the development impacts of the various clauses within the FEPA text. Interim EPAs were signed across the ACP countries in 2007 and since then, developing countries have voiced concern over a number of contentious clauses included in these agreements.

Most Favoured Nation Treatment

Article 1.1 of the General Agreement on Tariffs and Trade of the WTO states:

> *With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, and with respect to all matters referred to in paragraphs 2 and 4 of Article III,* any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.*

This article outlines the principle of Most Favoured Nation (MFN), which is one of the core principles of the WTO agreement. It means that countries cannot discriminate between their trading partners which is a major concern to the EAC partner states since they will have to if included in the EPA since it extend favourable treatment to the EU as well as any other major trading country that the EU signs an economic integration agreement with.

Article 16 of the FEPA states, "the more favourable treatment resulting from economic integration agreements". The article states in part that,

> *" (1) …the EC party shall accord to the EAC Party any more favourable treatment applicable as a result of the EC Party becoming party to an economic integration agreement with third parties.*

(2)…the EAC party shall accord to the EC Party any more favourable treatment applicable as a result of EAC Party becoming party to an economic integration agreement with any major trading country."

ACP countries, including the EAC, are of the opinion that the inclusion of this provision leaves little policy space to negotiate agreements with other countries. Also, that this clause contradicts the development provision of the EPA as this could potentially harm the development benefits accruing from this (Bilal and Ramdoo, 2010:18).

(b) Substantially All Trade

Article XXIV of GATT of the WTO covers Territorial Application, Frontier Traffic, Customs Unions and Free-trade Areas. Article 8(b) states, that a free trade agreement is understood to mean that barriers to trade are eliminated on "substantially all the trade" between the constituent parties to the agreement. EAC Partner states as well as the EU hold different views to the meaning of 'substantially all trade' and is, therefore, subject to subjective interpretation.

(c) Export Taxes

Article 15 of the FEPA text states that parties should not institute any new duties or taxes in connection with the exportation of goods to the other Party, on goods exported to the other Party that are in excess of those imposed on like products destined for internal sale. This article brings in restrictions on how the EAC member states use export taxes, for example, as trade policy instrument and instruments of revenue collection. EAC member states feel that this clause needs to be removed from the agreement/text as export taxes are in accordance with the WTO rules.

(d) Standstill Clause

The standstill clause concerns tariffs and EAC member states feel that this clause should be removed from the text as there is no standstill requirement in the WTO rules and does not provide for dynamism. Article 13 of the FEPA states that:

"… except for the measures adopted according to Articles 19 (Anti-dumping and Countervailing Measures) and Article 21 (Multilateral Safeguards), the Parties agree not to increase their applied customs duties in their mutual trade…"

The objective of economic and trade cooperation between the EU and the ACP states is to foster the smooth and gradual integration of the ACP states into the world economy as well as enabling the ACP states to play a full part in international trade.[2] There is a possibility that some of these objectives might not be fully realized if these issues are not ironed out, and this could also result into a prolonged EPA negotiation between the EAC and EU.

4. EPAs and development from a Kenyan perspective

One of the key concerns for EAC partner states has been the impact that the EPA agreement will have on their various economies and what opportunities or challenges this will portend for their various economies. Kenya, which is a developing country, is currently negotiating an EPA together with, Uganda, Tanzania, Rwanda and Burundi, which are all LDCs. It is important to establish whether Kenya will gain from trading with the EU.

The Structure of Kenya's Trade

Kenya's exports to the EU include food and live animals, crude materials, inedible, except fuels, machinery and transport equipment, miscellaneous manufactured articles and manufactured goods, classified chiefly by material. Kenya's imports from the EU include machinery and transport equipment, chemicals and related product not elsewhere specified (n.e.s.), mineral fuels material, manufactured goods classified chiefly by material, miscellaneous manufactured articles, food and live animals, crude materials, inedible, except fuels and commodities and transactions, not classified elsewhere (n.c.e.).

Table 3 shows that the EU is Kenya's main trading partner, emphasizing the crucial nature of the EPA negotiations. The EU is the main origin of Kenya's imports, making up 19 per cent of total imports. The EU is also the main destination of Kenya's exports, making up 24 per cent of total exports. From the figures, manufacturing takes the largest share of both exports and import, at 33 per cent and 59 per cent, respectively.

2 Article 1, ACP-EU Partnership Agreement (Cotonou Partnership Agreement).

Table 3: Kenya Trade Profile: Kenyan Economy Breakdown of Total Exports and Imports

Breakdown in Economy's Total Exports (%)		Breakdown in Economy's Total Imports (%)	
By main commodity group (ITS)[1]		By main commodity group (ITS)	
Agricultural products	55.5	Agricultural products	13.1
Fuels and mining products	6.0	Fuels and mining products	22.8
Manufactures	32.8	Manufactures	59.2
By main destination (2010)		**By main origin (2010)**	
1. European Union (2)	23.9	1. European Union (27)	18.6
2. Uganda	12.7	2. China	12.6
3. Tanzania	8.1	3. United Arab Emirates	12.1
4. United States	5.5	4. India	10.8
5. United Arab Emirates	4.6	5. South Africa	6.2

Source: World Trade Organization (2012b).

Table 4 outlines EU exports to Kenya. Machinery and transport equipment take the highest share in terms of trade followed by chemical and related products.

Figure 1 further provides the trend in the value of imports from the EU to Kenya over a span of five years. These figures, taken from the Kenyan economic survey (2012), show that imports from this select group of European countries into Kenya increased between the years 2007 and 2011. Imports from the United Kingdom (UK) increased significantly from Ksh. 28,789 in 2007 to Ksh. 46,728 in 2011. There has been an increase in the import of chemicals, hydraulic turbines and petroleum products during these years (GOK, 2012).

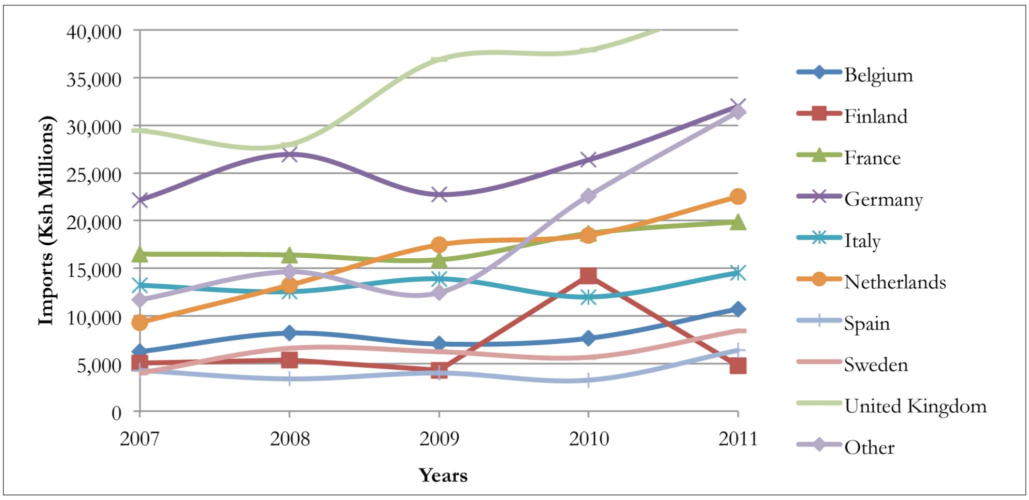
Table 5 captures Kenya's trade balance and trade with the EU. Listed are Kenya imports and exports from the EU, the EU's share of total imports and exports, as well as the balance of trade.

Table 4: EU Exports to Kenya

SITC Codes	SITC Section	Values $ Thousand	Share of Total (%)
SITC 7	Machinery and Transport equipment	985248.907	47.1
SITC 5	Chemicals and Related Products n.e.s	444475.933	21.3
SITC 6	Manufactured goods classified chiefly by material	179533.174	8.6
SITC 8	Miscellaneous manufactured articles	154049.232	7.4
SITC 0	Food and live animals	113581.821	5.4
SITC 3	Mineral fuels, lubricants and related materials	73196.873	3.5
SITC 2	Crude materials, inedible, except fuels	65545.958	3.1
SITC 9	Beverages and tobacco	42349.677	2.0
SITC 1	Commodities and transactions n.c.e	29,870.975	1.4
SITC 4	Animal and vegetable oils, fats and waxes	1,960.612	0.1

Source: Calculated using TRAINS data from WITS, World Bank (2012).

Figure 1: Kenya Imports by Country of Origin (European Union)



Source: Compiled using data from the Kenya Economic Survey 2012.

Table 5: Kenya, Trade with the European Union (Kenya's Trade Balance), millions of Euros

Period	Imports	EU Share of total Imports	Exports	EU Share of total Exports	Balance	Trade
2007	1465	19.6	965	27.3	-500	2430
2008	1491	16.7	1034	29.8	-456	2525
2009	1519	17.9	983	30.9	-536	2502
2010	1701	15.1	985	25.8	-716	2685
2011	-	-	-	-	-	-

Source: European Commission 2012

5. A Partial Equilibrium Analysis of the Impact of EAC-EU Economic Partnership Agreement on the Kenyan Economy

Methodology

A partial equilibrium model looks at the effects of a given policy action in the market(s) that are directly affected. This analysis does not take into consideration the economic actions between the various markets in a given economy (World Bank, 2011). The following describes a basic simulation exercise pertaining to Kenya which analyses the impact of an EPA on the economy. In this simulation we assume full liberalization of tariffs on imports from the EU into Kenya. The simulation results will cover trade creation, trade diversion, welfare effects and revenue impacts. The following scenario will simulate a full tariff elimination/liberalization of EU imports into Kenya for all products (all tariffs within the EAC and the EU come down to zero). To simulate how an EPA will impact on Kenya, we put into use the Single Market Partial Equilibrium Tool (SMART). SMART is a partial equilibrium model embedded in the World Integrated Trade Solution (WITS) software developed by the World Bank (WB) and a number of partners, which allows users to estimate the impact of tariff reductions on trade flows, tariff revenue, and consumer surplus for a single market at a time (World Bank, 2012). The SMART model uses Trade Analysis and Information System (TRAINS) database managed by United Nations Conference on Trade and Development (UNCTAD).

The rationale behind the SMART model is the Armington assumption, which poses that imports from different countries are imperfect substitutes. What this means is that, a good - as defined by the Harmonised System (HS) 6-digit level - imported from different countries are imperfect substitutes though they are similar (World Bank, 2011). Another assumption of the SMART model is that perfect competition is assumed. The simulations applied take into account full liberalisation (100%), tariff cuts are at 0%, with products classified at the Harmonised System (HS) 6 level. Although sensitive products have already been defined by Kenya's negotiators, they are included in this simulation exercise as the main focus here is to give a general indication of the trade revenue and welfare effects as well as the trade creation and welfare effects.

6. Results of the Simulations[3]

Trade Creation

Trade creation is as a result of tariff reductions and can be described as a scenario where tariffs are lowered, making goods more affordable to consumers in a particular market. In a scenario where there is full liberalization, the European market is receiving duty-free access to the EAC market as all tariffs have been brought to zero. Table 6 shows that total net imports, as expressed in the simulation, are expected to increase by approximately $143 million as a result of tariff liberalization. There will be an increase of EU exports into Kenya to the tune of $143 million due to the lowering of tariffs which could make these goods cheaper. We could also make the assumption that more of these goods would be consumed.

Table 6: Results of Trade Simulations (1,000 USD)

Trade Creation Effect	Total Trade Diversion	Welfare Effect	Revenue Impact
142, 923.586	-14,981.082	18,232.374	-142,898.303

Source: Computed using the WITS-SMART model.

3 This scenario takes into account full liberalization, including sensitive products. The inclusion of sensitive products could further reduce the revenue, welfare trade creation, and diversion effects.

Increase in EU exports to Kenya

Table 7 shows exports before and after full liberalization from the EU to Kenya. This gives an indication of how exports to Kenya from the various countries in the EU are bound to change before and after the full liberalization scenario and which EU countries will benefit from this. Germany, France, Italy, Netherlands and the United Kingdom as shown in the table would experience a significant increase in their exports to Kenya. This increase in exports could have various implications on the import patterns in Kenya. This could also be an indication that goods imported to Kenya from the EAC region could face reduced market share.

Trade Diversion

Trade diversion will occur when goods from outside a regional economic community (REC) displaces goods that are traded within the REC after liberalization. Table 6 shows the potential total trade diversion to Kenya is approximated at -$15 million. One of the negative effects would be to her EAC Partner states who could have their exports to Kenya displaced by imports from Europe due to the removal of tariffs. Trade diversion is obviously not seen to improve the welfare of countries affected.

Table 7: EU Exports to Kenya after Full Liberalization (1,000 USD)

Exporters from EU	Exports Before	Exports After	Export Change
France	206,562.326	230,399.266	23,836.940
Belgium	90,854.044	101,898.664	11,044.619
Denmark	74,736.998	77,150.363	2,413.365
Finland	55,658.290	57,750.054	2,091.764
Czech Republic	15,253.880	16,098.486	844.606
Austria	10,978.452	13,561.427	2,582.975
Cyprus	1,248.671	1,362.068	113.397
Estonia	418.223	519.608	101.385
Germany	294,366.198	328,722.549	34,356.352
Italy	179,868.654	211,636.688	31,768.034
Lithuania	15,997.872	16,013.704	15.832
Hungary	8,645.605	9,673.806	1,028.201
Greece	2,792.409	3,489.357	696.948
Malta	1,670.062	1,696.818	26.756
Ireland	27,362.407	29,876.422	2,514.014
Luxembourg	662.230	780.882	118.652
Latvia	95.459	97.752	2.293
Netherlands	225,918.893	254,865.688	28,946.792
Sweden	80,801.611	96,097.583	15,295.973
Spain	51,832.810	58,302.503	6,469.693
Poland	17,492.476	24,674.498	7,182.022
Portugal	8,325.910	9,325.928	1,000.0
Slovak Republic	3,704.396	3,954.309	249.913
Slovenia	818.950	973.259	154.309
Bulgaria	13,331.634	13,847.514	515.880
Romania	24,255.806	25,026.252	770.446
United Kingdom	472,621.155	535,562.183	62,941.030
Total	1,886,275.42	2,123,357.63	237,082.19

Source: Computed using the WITS-SMART model.

Welfare Effect

A situation where Kenya's imports increase by $143 million may not be the best effects in terms of the effect on local producers as well as the government. On the other hand this increase in imports could have a positive impact on consumers as they could have access to goods at lower prices. Welfare gains could also manifest in technology that is part of the imports and this could be welfare enhancing for various manufacturing industries. The welfare value in this case is also known as the consumer surplus. Table 6 shows that the potential welfare effect here is approximately at $18 million. Consumers would be able to access goods at a lower value due to the effect of tariff liberalization.

Revenue Impact

According to the simulations tariff revenue to Kenya will decrease by approximately $ 142 million due to tariff cuts on imports from the EU. This would be an expected result in most situations where there is a reduction of tariffs. This could result in an imbalance in the allocation of resources to other public utilities. There still remains, however, room for adjustment in this figure as revenue is impacted by a number of variables. A solution to this would be to explore the idea of setting up a new fiscal plan to look into the generation of revenue to counter this loss. Another option would be to seek financial support from the EU.

Review of Existing Quantitative Literature on the Analysis of EPA in the East African Region

Most of the literature on the effect of EPAs on ACP countries shows that trade liberalization would mostly have a positive effect on the various economies. In their paper "Some Simple Analytics of the Trade and Welfare Effects of Economic Partnership Agreement", Milner and McKay look at the short-run welfare consequences, static effects on trade flows and tariff revenue of an EPA with the EAC (in this case only Kenya, Tanzania and Uganda were included in this exercise). The results from their paper show that the calculated revenue losses are quite large. The Kenya Institute for Public Research and Analysis (KIPPRA) in their 2005 publication, "Assessment of the Potential Impact of Economic Partnership Agreements (EPAs) on the Kenyan economy" charts out the potential gains, potential losses and welfare effects of an EPA. The KIPPRA report estimates additional imports from the EU of about Ksh.7.1 billion, potential revenue loss of Kshs. 6.9 billion and potential trade diversion to the tune of Kshs. 2.5 billion of imports from the EU.

7. Conclusion

This bulletin highlighted the broad area of EPAs, from a historical and developmental perspective as concerns the EAC with a focus on Kenya. Kenya's EPA negotiations are currently ongoing. While progress has been made since the start of the negotiations, contentious issues still remain as bottlenecks to this process. Some of these issues include: the Most Favoured Nation (MFN) Clause, Export Taxes, Standstill Clause, among other issues. Kenya should maximize on her available policy space to ensure that negotiated EPAs are developmental and beneficial to the country.

From the analysis, we give an overview of the trade creation and diversion effects. The effects of this will depend on how well policy measures are applied to handle any adverse effects from this. Revenue loses likely to occur from full liberalization could be mitigated by looking for alternative revenue sources, while welfare effects could be enhanced with the inclusion of the right policies.

The potential developmental impacts (whether negative or positive) of an EPA, as suggested from the results of the simulations, point to further policy concerns that would need to be taken into consideration as the negotiations continue. Some of these considerations should focus on strengthening the competiveness of Kenya's industries and a focus on deeper integration at the EAC level to protect goods from potential displacement or trade losses. Other considerations are the adjustment costs that might be needed to mitigate the potential loss of revenue as a result of the removal of tariffs, as well as proper polices being put in place to ensure that consumers are able to benefit from this agreement in terms of the welfare effects being passed on to the consumers.

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