CONSULTING ASSISTANCE ON ECONOMIC REFORM II

DISCUSSION PAPERS

The objectives of the Consulting Assistance on Economic Reform (CAER II) project are to contribute to broad-based and sustainable economic growth and to improve the policy reform content of USAID assistance activities that aim to strengthen markets in recipient countries. Services are provided by the Harvard Institute for International Development (HIID) and its subcontractors. It is funded by the U.S. Agency for International Development, Bureau for Global Programs, Field Support and Research, Center for Economic Growth and Agricultural Development, Office of Emerging Markets through Contracts PCE-C-00-95-00015-00 and PCE-Q-00-95-00016-00. This paper was funded by contract PCE-C-00-95-00015-00, Task Order No. 23.

Assessing Export Platforms: The Case of Kenya

Graham Glenday
David Ndii

CAER II Discussion Paper No. 75
May 2000

For information contact:
CAER II Project Office
Harvard Institute for International Development
14 Story Street
Cambridge, MA 02138 USA
Tel: (617) 495-9776; Fax: (617) 495-0527
Email: caer@hiid.harvard.edu

Assessing Export Platforms: The Case of Kenya[1]

by
Graham Glenday
and
David Ndii[2]

September 29, 1999

1 This paper was prepared under the Equity and Growth through Economic Research/Trade Regimes and Growth Cooperative Agreement No. AOT-0546-A-00-5073-00 of the Division of Strategic Analysis, Office of Sustainable Development, Bureau for Africa, U.S. Agency for International Development (USAID). Views and interpretations in this paper are those of the author(s) and do not necessarily reflect the view of the U.S. Agency for International Development.

2 Graham Glenday is Fellow of the Institute and Director of the Public Finance Group at the Harvard Institute for International Development, and is currently Advisor to the Minister of Finance, Kenya. David Ndii is Lecturer in the Department of Economics, University of Nairobi, Kenya.

Table of Contents

Executive Summary

Export platforms are often cited as critical elements of successful entry into developed country markets, although it has not been established if they are necessary for success or if an appropriate policy regime would suffice. In the case of Kenya, overall exports fluctuated dramatically since the initial implementation of export platform programs in the late 1980s, and yet it is difficult to study the effect of the export platforms on the total exports because the macroeconomic conditions changed dramatically during the same time period.

Kenya embarked on trade liberalization and export promotion programs in 1987 in response to a deterioration of export performance over the preceding decade. Three export promotion platforms were introduced, namely a manufacturing under bond (MUB) scheme, an export processing zone (EPZ) scheme, and a duty or value-added tax (VAT) exemption scheme. The first two targeted new investments, the third targeted existing manufacturers.

The MUB platform showed considerable potential when it was first established in 1988. It provided bonded factories that were allowed duty-free import of plant, equipment, spares, and raw materials to manufacture goods for export. The facility became an attractive platform for contract garment manufacturing for the U.S. market, but this suffered a major setback in 1994 when the U.S. trade authorities revoked Kenya's quota for some items. If the quota had not been revoked, it is possible that success still might not have been sustained, given the subsequent appreciation of both the exchange rate and the real wage, and the precipitous fall of Southeast Asian currencies and labor costs following the financial crisis.

The EPZ scheme was established in 1990 and was fully operational in 1993. Primarily targeted at manufacturers serving the domestic market, the program offered generous incentive packages to businesses that were established in designated EPZ locations. For customs purposes, these EPZ locations are considered outside the customs territory, such that sales from Kenyan businesses to an EPZ are treated as exports, and vice versa. In theory, this program would have been attractive, with its duty and VAT exemptions on imported inputs used in the production of the export, as well as its allowance of firms to operate freely in foreign exchange at a time when this commanded a market premium. However, the total exports and employment contributed by EPZs remains far below initial expectations, and investor response has been poor. This is due in part to the foreign exchange liberalization in 1993–94, which lessened substantially the EPZ advantage in free operation in the foreign exchange. Furthermore, the common market system that developed in Africa over the 1990s became increasingly attractive, and the fact that EPZ sales were considered exports meant that EPZ firms were ineligible to participate in the common market.

It is difficult to isolate and study the effect of the MUB and EPZ platforms on the total exports in the 1990s, because a preferential regional market was put in place and increased significantly its share of exports during the same time period. The Common Market for Eastern and Southern Africa (COMESA) and East African Cooperation are both designed to allow all participating countries to trade within the region duty-free, and will eventually charge all external countries a common tariff. This system eventually accounted for almost one-third of Kenya's exports, in contrast to the combined MUB and EPZ total of just over one percent of total exports.

Exporters using the most flexible export platform of the three, the duty and VAT exemption program, have generated as much as 35% of total exports in the past, but their share has decreased with the overall decline in exports to 31%. These totals are highly concentrated, however, among the largest exporters, and 50% of these exports were directed at common market countries. This means that the current discussion in COMESA regarding the future role of export platforms by the COMESA has major significance on Kenyan regional customs and trade policy.

Overall, exports from Kenya showed only modest real growth through 1992, increased dramatically during 1993–96, and fell substantially over 1997–98. Given the changes in macroeconomic factors during this time

period, one cannot attribute the sharp increase to the implementation of export platforms. In addition to the development of the common markets, the foreign exchange liberalization affected trade, as did the appreciation in real wages and exchange rate. The atmosphere built during this time caused a decline in exports, and export platforms programs did not generate the critical mass of labor-intensive export processing that was anticipated.

Arguably, the most successful export platform, the more flexible duty and VAT remission program, has contributed to the remarkable growth of manufactured exports to the regional market. It has been noted, however, that the COMESA and the East African Cooperation may plan to phase out export incentives over the next five years, which would have a severe impact on import duty revenues, and export business supported by the duty and VAT exemption program. In addition, tariff reductions are expected to continue, which will further erode the incentives from export platform programs. If the right macroeconomic environment—namely, lower real interest rates, weaker exchange rate, and lower wages—is combined with a stronger economic infrastructure and an increase in flexibility of export platforms and labor markets, then Kenya's export prospects in labor-intensive manufactures could brighten considerably.

1. Introduction

Kenya embarked on trade liberalization and export promotion programs 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 % in the 1970s, to 16.97 % over 1980–84, and declined even further to 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 labor-intensive manufactures. The first two, a bonded warehouse or manufacturing under bond scheme (MUB), and an export processing zone scheme (EPZs), targeted new investments. The third, a duty and VAT exemption scheme (known by the acronym EPPO for Export Promotion Programmes Office), targeted 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 labor-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 labor 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, focusing 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 1992–94 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 favorable export conditions have not been sustained as both the real Ksh/US$ exchange rate. The average wage rate in US$ terms had, by 1997, reverted to pre-1990 levels and then in the case of the exchange rate, it had exceeded those levels, which 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 regional market has absorbed over 100 percent of the cumulative increase in processed exports over the period 1993–98, reflecting a 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, for 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 1993–98 amounts to just over one percent of total exports. By contrast, exporters using the more flexible EPPO duty/VAT exemption program 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 program 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 reflecting the tax value of the program declining with lower duty rates. That said, the MUB platform did show considerable potential. The facility became an attractive platform for contract garment manufacturing for the U.S. market, but this suffered a major setback in 1994 when the U.S. trade authorities revoked Kenya's quota for some items (shirts, tee shirts and pillow cases) citing transhipment 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 labor costs following the financial crisis.

Kenya has 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. A large proportion of this labor force is engaged in a dynamic and highly competitive informal sector (somewhat analogous to Asia's "sweatshops"), 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 labor-intensive export processing. Reliance on physical controls rather than on accounting controls, and the 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 central purpose 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 to their world or border price levels is important in gaining export price competitiveness for the exporter.

Another way of expressing this objective is to say that 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 schemes.

The net rents or pure profits (π) of a business venture selling quantity, Q, at a price inclusive of import tariffs of $p(1 + T_Q)$ after incurring labor and other non-tradeable costs of wL, tradeable variable input costs inclusive of import tariffs of $mM(1 + T_M)$, and capital rental costs, gross of taxes on the capital income or on the capital assets and inclusive of import tariffs, of $(r + \delta + t_K)K(1 + T_K)$ are given in the following equation.[3]

[3] 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 that are zero rated to avoid financing the input VAT while waiting for the refund or credit payment.

$$\pi_1 = pQ(1 + T_Q) - [wL + mM(1 + T_M) + (r + \delta + t_K)K(1 + T_K)] \quad (A)$$

where p, Q, and T_Q are the world price, quantity, and tariff rate of the product, respectively; m, M, and T_M are the world price, quantity, and tariff rate of tradeable variable inputs; and r, δ, t_K, and K are the rental rate, depreciation rate, tax rate, and capital value of capital assets. 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:

$$\pi_0 = pQ - [wL + mM + (r + \delta + t_K)K] \quad (B)$$

The net subsidy received by the business from the tariff protection is the difference ($_1$ - $_0$) and can be written as:

$$S = pQ\,T_Q - [mM\,T_M + (r + \delta + t_K)K\,T_K] \quad (C)$$

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

$$s = T_Q - [\alpha_M\,T_M + (\alpha_K + \alpha_t)\,T_K] \quad (D)$$

where the α'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 $T_Q \geq T_M$ and T_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 $T_Q = 0$ or

$$s = -[\alpha_M\,T_M + \alpha_K + \alpha_t)\,T_K] \quad (E)$$

To avoid this negative subsidy or negative protection, export promotion programs or export platforms typically make T_M on tradeable variable or current cost inputs zero, and sometimes also make T_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, α_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 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. Overall, the domestic currency is expected to devalue with general import tariff reductions. This will favor the production of tradeables, including exports. When the average import tariff rates are lower in an economy, there is 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

T_M can be made zero either through import duty exemptions or through drawbacks on 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 the 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 are referred to as second-stage indirect exporters. These second-stage indirect exporters can then be offered duty exemptions or drawbacks on imported inputs used to produce inputs for a first-stage indirect exporter that supplies inputs to an exporter. In theory, this chain of indirect exporters can be lengthy. In practice, it seldom goes back more than three or four stages.

This problem of complex chains of input-output relationships 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 (setting T_K to zero). The reason for this is that production of a company does not always go into exports. If the export share of production is low and the product receives import protection, then a decrease of import tariffs on all capital investments merely raises the effective subsidy received from supplying the domestic market. This is seen in equation (D) above. As a 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, in cases where the estimated import duty contents are paid upon export of a particular class of goods, 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 t_K to t_K', and lowered the share of capital taxes from α_t to α_t', then the effective subsidy rate in (D) becomes:

$$s = T_Q - [\alpha_M T_M + (\alpha_K + \alpha_t') T_K + \alpha_t' - \alpha_t)] \qquad (F)$$

The subsidy rate on export producers is therefore increased by $(\alpha_t - \alpha_t')(1 + T_K)$. 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 prohibiting 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. For example, an EPZ program that offers full import duty exemptions and other tax incentives, but is limited to firms producing primarily for export and 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 EPZ. 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 thus 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 B. With these adjustments, the net gain from participation in an export program offering $T_M = T_K = 0$ becomes:

$$\Delta = [\alpha_M T_M + (\alpha_K + \alpha_t) T_K)] + [(\alpha_L - \alpha_L') + \alpha_M - \alpha_M') + \alpha_K + \alpha_t - \alpha_K' - \alpha_t') - B] \quad (G)$$

Real exchange rate effects

The pure profits of a domestic manufacturer of tradeables are shown above in equation (A) in terms of world prices expressed in domestic currency units. These prices could be alternatively 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:

$$\pi_t/(pQ) = (1 + T_Q) - [\alpha_M (1 + T_M) + \alpha_K + \alpha_t) (1 + T_K)] - wL/(p^w E Q) \quad (H)$$

then it is clear that the pure profits rise with a devaluation in the domestic currency, where E rises, as relative cost of non-tradeables in the last term of equation (H) falls. This expression also shows that if all the effective import duty rates, T, decline, then the pure profits will decline for manufacturers of importables, but increase for manufacturers of exportables (with $T_Q = 0$). 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 offset partially 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 with the reduction in the import duty

content of their costs, as well as indirectly with 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.

The equation (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). Those with low domestic value added will focus on their effective tariff protection and will be very sensitive to the rate of output protection (T_Q) relative to input duties T_M). Such manufacturers will also 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, for customs purposes all member countries in a common market are treated as one country. The common market members have a single common tariff charged on imports from all external countries, a "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 within the common tariff protective wall. That is, they do not qualify as exports under any export promotion program, and they 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 equation (D).

This ideal situation, however, has not applied in the case of Kenya and other members of the Common Market for Eastern and Southern Africa. Intra-regional tariffs have been systematically reduced during the 1990s, such that most trade between members of COMESA countries of goods originating in 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 more complex than the common external tariff. In addition, trade between member countries is still generally treated as importation or exportation 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 became complete T_M and $T_K = 0$), the effective subsidy rate given by equation (D) would rise to the import duty rate on the good exported within the region, that is, $s = T_Q$. This means that the export platform would bias 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: $s = T_Q - \alpha_K + \alpha_t) T_K$. Exports from an EPZ can then be an exception as an 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 may 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, such that all member countries B 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 Cooperation 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 strategy involved in designing and administering the removal of the import duty content from exports. As noted above, when a domestic firm purchases tradeable inputs from other domestic firms (rather than importing them directly), problems arise in identifying and removing the full import duty content from the inputs. Multiple stages of domestic production may 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, it becomes a challenge to remove only the duty content in capital assets consumed in producing the exports. In particular, a duty exemption on capital goods presupposes that the goods will be used to produce only exports. This may not prove to be the case. WTO/GATT rules require only actual duties paid on inputs physically incorporated in the export to be exempted or drawn back. However, countries have resorted to altering estimations of import duty contents on specified classes of exports such that they 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 done using input-output data and/or industrial surveys of the production, costs, and effective import tariffs. While in theory this approach would 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 introduces a different set 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 the level of wastage. Second, within any class of goods, there will be a wide variety of products in terms of size, quality, materials employed, etc. These factors will result in a variation in the true compensation rates of 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 decreases the effectiveness of the program. A second problem with the approach of estimating the compensation rates by types of export is that it requires a major investment, up front and ongoing, 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 that exempt 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. The compensation of 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 on 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 the program does not effectively reduce T_M and T_K all the way to zero.

Choice of export platform

Export platforms are generally designed to remove the negative protection expressed in equation (E) or provide the net gain given in equation (G) through import duty exemptions or drawbacks on raw materials and possibly capital equipment, and also through income tax incentives. However, 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 decide not to use an export platform. This usually happens when an exporter finds that the pure profits, as given in equation (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:

$$\pi_1/(pQ) = (1 + T_Q) - [\ \alpha_L + \alpha_M\ (1 + T_M) + \alpha_K + \alpha_t)\ (1 + T_K)\ ] \qquad (I)$$

With an export platform, the pure profit share is:

$$\pi_1'/(pQ) = (1 + T_Q\ ) - \alpha_L' + \alpha_M'\ (1 + T_M'\ ) + \alpha_K' + \alpha_t'\ )\ (1 + T_K'\ ) + B \qquad (J)$$

Each component of the costs can differ when an export platform is used, compared to the cases when no platform is used. For this reason, all the cost variables in (J) are marked with a prime.

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

$$\Delta = (\alpha_L - \alpha_L'\ ) + \alpha_M - \alpha_M'\ ) + \alpha_K - \alpha_K'\ ) + \alpha_t - \alpha_t'\ ) - B$$

$$+ (\alpha_M\ T_M - \alpha_M'\ T_M'\ )\ + \alpha_K\ T_K - \alpha_K'\ T_K'\ ) + \alpha_t\ T_K - \alpha_t'\ T_K'\ ) \qquad (K)$$

An exporter is expected to choose to use an export platform if) 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, equation (K) can be reduced to:

$$\Delta = \alpha_M\ T_M + (\alpha_K + \alpha_t\ )\ T_K \qquad (L)$$

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 generally will not be the case, however. On one hand, compliance costs can be reduced by lowering license 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, raise the rents, increase reporting and inspection requirements, and bring a business into the formal tax net (which may also affect tax compliance in related businesses). It may also restrict the flexibility in product and volume of production choices in response to market demand shifts that would lower its utilization capacity 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 when 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 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 a 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 on 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.[4] 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 gave rise to a major critique of the program and the trade reform program adopted in the late 1980s replaced it with a duty exemption scheme. The compensation program was finally 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, resulted in a higher probability of over compensation for a higher share of exports. Second, the scheme benefited a few large firms which typically accounted for less than 5 percent 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.[5] Third, the program had become embroiled in a major export fraud in 1992–93. Finally, it had a simple ad valorem payment structure, that is, no direct relationship existed between compensation and the import duties actually paid on inputs physically incorporated in the exports. This structure placed it in the class of prohibited subsidies which could be countervailed by an importing country under WTO/GATT rules.

Manufacturing under bond

The manufacturing under bond scheme (MUB) was established in 1988 under the structural adjustment policy regime. It provided bonded factories that were allowed duty-free import of plant, equipment, spares, and raw materials to manufacture goods for export. The program also offered an investment incentive in the form of

[4] 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.

[5] Bellhouse, Mwangi, Ernst, andYoung, *Export Compensation and Import Duty Remission Study.*

favorable income tax treatment of capital expenditures and, following the introduction of a value added tax started in 1990, imports by MUBs and their domestic input purchases were zero rated.

MUB plants and equipment qualify for 100% write-offs against taxable profit in the year they are put into use. Other enterprises in Kenya are offered tax breaks on investment on the "split system" where a proportion of investment, presently 60% for most plant and equipment, is expensed immediately. The remainder of the investment 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 receive 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. The MUBs require Customs to verify physically the inventories of imported raw materials, manufactured products, waste, and scrap material, as opposed to the "off-site" accounting controls. This in turn requires the factories to meet physical specifications. There are no restrictions on location, as Customs can generally provide officers to inspect the factory at desired locations. Although 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 given the preferential capital investment allowance confer advantage over regular domestic factories.[6]

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 "footloose" manufacturers by providing the following: 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); a duty and VAT waiver on imports of plant equipment and raw materials (except for motor vehicles not used exclusively in the zone, and motor vehicle spare parts); exemption from foreign exchange controls; and expedited licensing at reduced business license fees. Manufacturers in the EPZ program are exempt from rent and tenancy controls, but not 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 continued to drop throughout the 1990s and reached 30% in 2000.

EPZs are heralded 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 and licensed by the EPZ Authority. Although the program is targeted primarily at new foreign direct investment, Kenyan companies are allowed to establish EPZ subsidiaries. They cannot, however do part of its business inside and part outside an EPZ. Specific provision were also introduced into the Income Tax Act to prevent "tax straddling" between EPZ enterprises and related domestic companies through transfer pricing. For example, a domestic company providing administrative services to a related EPZ company may not charge the services against the taxable

[6] 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.

income of the domestic company, or shift 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. Because an EPZ is regarded as outside of the customs territory, importing countries may not recognize 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, a firm must incur 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. Otherwise, if a firm does not obtain permission from the authority, the EPZ status will restrict 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 "sweatshop" 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 that are physically incorporated in the exported product or consumed in the production of the export.[7] It excludes exemptions for plant, equipment and machinery. The program is administered by the EPPO in the Ministry of Finance.

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 nine 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 (a guarantee from 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

[7] Consumables include items such as testing chemicals and cleaning materials, but exclude lubricants and fuels, except for coal, coke, and residual fuel oils.

free (primarily pharmaceuticals, agricultural inputs and books)m 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 US$ 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 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 U.S. market. The program was set back by the reduction of Kenya's garment quota by the U.S. trade authorities in 1994, and the subsequent appreciation of the exchange rate and wage rate. By 1997, all but ten 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, as shown in 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. It 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 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, the 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 would 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 U.S. 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 U.K. 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).

The contribution by EPZs in terms of exports and employment remains far below initial expectations, which is shown in 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 1993–97 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% 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.

One factor cited as a reason for poor investor response to EPZ incentives was the ineligibility of EPZ firms for preferential treatment in the regional market, which is the main market for Kenyan manufactures. Another was the fact that under COMESA rules of origin, EPZ goods are treated as foreign goods. Infrastructure deficiency is another factor cited, particularly the deficiency in transport infrastructure, and the unreliable power and water supply. 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	License 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, 1993–98.

	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 B 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 reach a plateau 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 3–4% down to 2–3%. 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, 1991–98.

Year	Direct exporters	Indirect exporters	Other duty exempt	Number 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 (see table 5). On an annual basis, direct exporters have typically 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 60–70% of all the exports by direct exporters in the program. These top 20 exporters qualify for 40–50% of the duty exempt imports and duty remissions under EPPO (see table 6). The direct exporters utilizing the program cover more or less the entire spectrum of Kenya's processed exports, including the following: processed foods (e.g., 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 Cooperation would have a significant impact 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	Number 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
By Import Value (CIF)					
Top 10 firms	22	20	25	27	23
Top 20 firms	42	39	46	51	43
By Duty Remission Value					
Top 10 firms	26	27	31	27	34
Top 20 firms	41	49	52	51	51

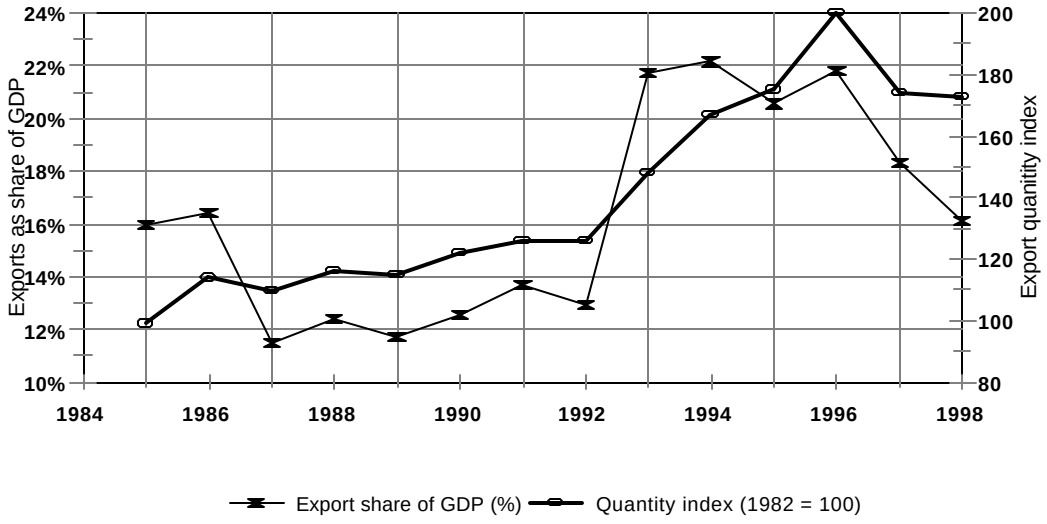
Source: EPPO, Ministry of Finance.

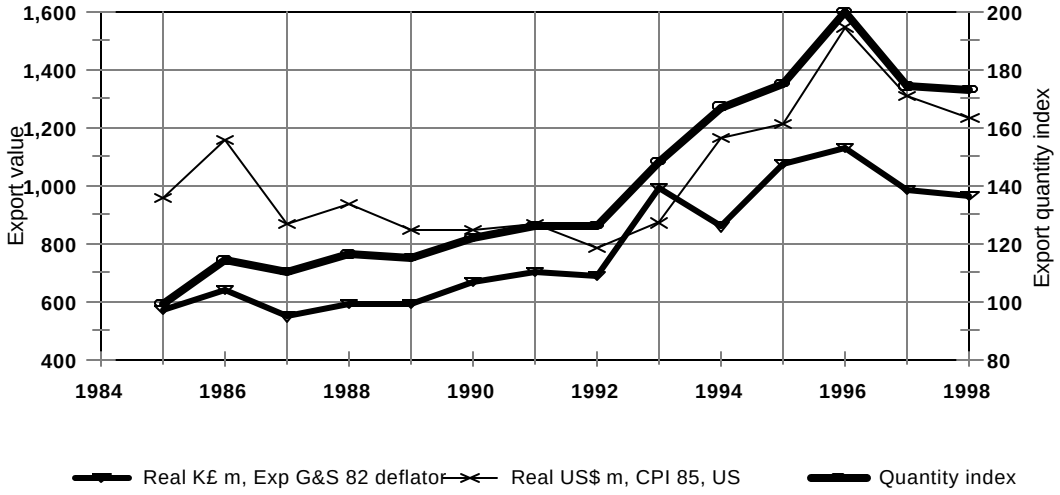
5. Macroeconomic Policy Factors

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 1997–98. 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.

Figure 1. Domestic exports, Kenya, 1985–98.




1,600
1,400
1,200
1,000
800
600
400
Export value
200
180
160
140
120
100
80
Export quantity index
1984
1986
1988
1990
1992
1994
1996
1998
Real K£ m, Exp G&S 82 deflator
Real US$ m, CPI 85, US
Quantity index

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 %.[8] The government embarked on a phased tariff reductions (particularly in the high-rate bands) and rationalizion 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 15–25% 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 of 1993 when the import licensing requirements were abolished 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% over the period 1981–92 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 over the period of 1986–98 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 devaluation in Asia, South America and southern Africa, is evident in the worsening export performance after 1996 as shown in figure 1.

[8] Average of all ad valorem tariffs in customs tariff schedule. Tariffs are weighed by number of tariff items recognized in the tariff schedule.

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 data on wages are unlikely to have a significant 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 "sweatshop type" enterprises (called the "jua kali" sector), where earnings are considerably lower than formal sector wages and lower still in the rural areas, which means that these data present only a partial picture of the labor market. Even within the formal sector, there are large wage differentials between unionizable workers (those on "permanent" employment) and more temporary or contract employees. Typically, the former earn twice the wages of the latter for comparable work.

Table 7. Labor productivity and wage costs in Kenyan manufacturing, 1990–98.

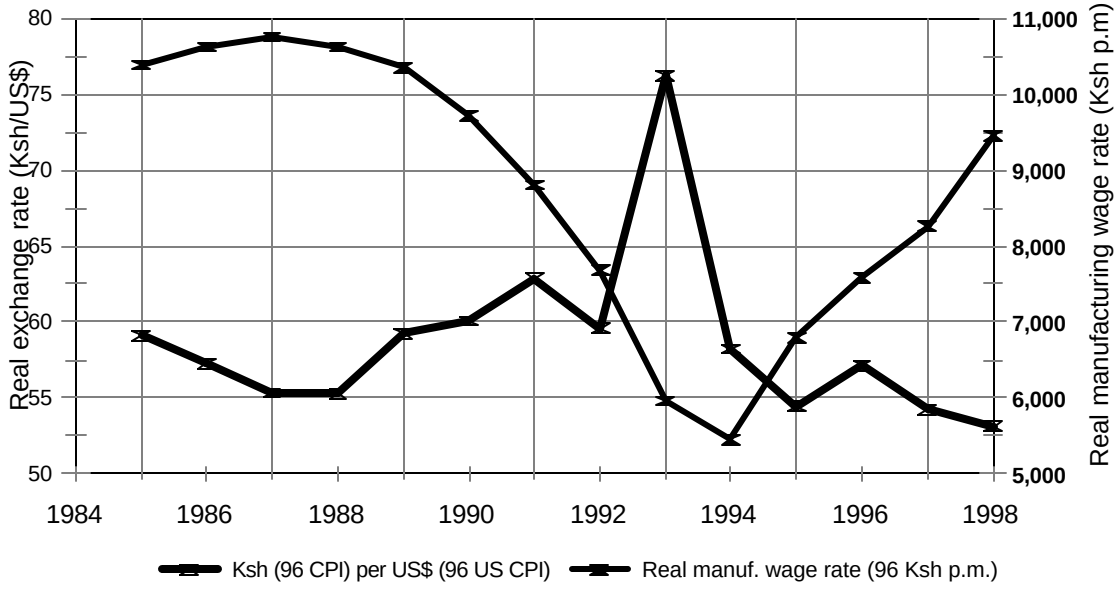
	1990	1991	1992	1993	1994	1995	1996	1997	1998
Manufacturing Sector									
Employment growth (%)	2.7	0.6	0.7	1.7	2.0	3.7	2.8	1.9	1.1
Output growth (quantity index) (%)	5.3	2.8	1.3	1.8	1.9	3.8	3.2	1.9	1.4
Implicit labor productivity growth(%)	2.6	2.2	0.5	0.1	-0.1	0.2	0.4	0	0.3
Wage cost/Gross output (%)	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	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$	161	139	129	76	93	125	133	153	178
Economy Aggregates									
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 U.S. 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 U.S. dollar cost of manufacturing labor jumping by 114% between 1994 and 1998 (or 92% in real U.S. dollar terms). Meanwhile, 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 $(w/E)(L/Q)/p^w$. The real wage rate (w) in shillings increased while the exchange rate (E) strengthened giving a major increase in the U.S. dollar cost of labor (w/E). Little or no improvement is noted in labor productivity (Q/L) and real international prices (p^w) 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

Figure 2. Real exchange rate (Ksh/US$) and Real Manufacturing Wages, 1985–98.



Regional market developments

Kenya, Uganda, and Tanzania established a common market, the East African Cooperation, 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 Cooperation 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 Cooperation, 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 Cooperation initiative is now 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 under-utilized 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.[9] 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.[10]

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 like the "footloose" 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 of 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 new FDI, and only about one-third 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 % of annual gross private investment.[11] 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 U.K. has been the single most significant origin of FDI. U.K. 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 the duty/VAT exemption program) but it was only after trade licensing was lifted and, more importantly, foreign exchange controls were lifted in 1993–94 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 U.S. 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.

[9] "Comparative Advantage, Competitiveness and Supply Capacity in Kenya's Manufacturing Sector." Draft Report by Peter Hopcraft for the Export Promotion Council, September 1998.

[10] 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.

[11] World Bank data on foreign direct investment in Kenya indicates an annual average investment of US$ 34 million in the 1980s, and $19 million over the period of 1990–96.

Looking behind the broad categories of exports, it becomes clear 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.

Table 8. Destination of Kenyan exports, 1990–98.

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

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 confectionary 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 of these 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 B 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 has strengthened again in real terms and labor costs in U.S. dollar terms rose sharply. These trends reversed the competitiveness of Kenyan exports dramatically. Over 1996–98, Kenyan exports declined by 5.8% in U.S. dollar terms. 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 9. Composition and destination of Kenyan exports, 1990–98.

Destination/Composition	1990–92	1993–95	1996–98
COMESA, value (US$ m per annum)			
Primary	9	17	30
Processed/Manufactured	161	459	634
All exports	170	476	664
COMESA, composition (%)			
Primary	5.5	3.6	4.5
Processed/Manufactured	94.5	96.4	95.5
All exports	100	100	100
COMESA, growth contribution(%)			
Primary		4.6	6
Processed/Manufactured		122..3	106.1
All exports		74.7	62.9
Non-COMESA, value (US$m per annum)			
Primary	571	728	889
Processed/Manufactured	424	370	397
All exports	995	1098	1286
Non-COMESA, composition (%)			
Primary	57.4	66.3	69.1
Processed/Manufactured	42.6	33.7	30.9
All exports	100	100	100
Non-COMESA, growth contribution (%)			
Primary		95.4	94
Processed/Manufactured		-22.3	-6.1
All exports		25.3	37.1
TOTAL, value (US$m per annum)			
Primary	580	745	919
Processed/Manufactured	585	829	1031
All exports	1165	1574	1950
TOTAL, composition(%)			
Primary	49.8	47.4	47.1
Processed/Manufactured	50.2	52.6	52.9
All exports	100	100	100
TOTAL, growth contribution (%)			
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 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 % of total Kenyan exports between 1993 and 1998 as compared to a combined share of less than 2 % that accounted for MUB and EPZs. 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) has been made in the traditional footloose labor-intensive industries to supply external markets. The program is a flexible and

is 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 or manufactured export growth has been from utilizing existing capacity to exploit the regional market, which both consumes similar goods, and gives preferential access under COMESA.

The main conclusion to be drawn from this analysis is that export platforms that are primarily designed to support dedicated export manufacturing (EPZ and MUBs) are much less attractive than more flexible structures such as the EPPO duty exemption program, which can support regional trade of the same goods that are produced for the domestic market. The duty exemption program has been used extensively by the major local manufacturing and processing companies that produce items like beer, cigarettes, cement, paper, corrugated iron sheeting, vegetable cooking oils, and soaps. 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 10. Export composition by export platform, 1993–98.

SITC Classification	Share of exports by export platform (%)				Share of total exports
	EPPO	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
TOTAL	**35.11**	**1.15**	**0.03**	**63.72**	**100.00**

Source: Ministry of Finance, customs data.

7. Conclusions

Kenya's export platforms have not generated the critical mass of "footloose" labor-intensive export processing that was anticipated, despite the country's relatively large skilled and semi-skilled industrial labor force. In theory, this labor force could be engaged to produce labor-intensive manufactures (notably garments and footwear) for the world market. One explanation is that scope for building on the existing capacity to produce up-market consumer goods is limited by the low-income and small regional market by world standards. (The exception might be footwear and clothing, but these the quality demands are substantially different.) The situation is the same in most, if not all, Sub-Sahara African countries.

A second reason is that in order to attract significant export-dedicated investment, the following criteria are required: the domestic investment environment must be extremely attractive; labor must be of low cost and high productivity; transport must be dependable and cost effective; utilities and other infrastructure services must be available; and there must be comparatively low business risk. On a wide range of these competitive factors, many African economies are not sufficiently attractive. Evidently, export platforms based on tax incentives 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, 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 the country should be deregistered and established as regular industrial parks. Furthermore, it would be best 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 EPPO 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 phasing out export incentives from regional trade within five 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 supporting direct and indirect exports outside the region, as well as removing negative protection from the duty-free or exempt goods produced for the local market. This flexibility arises from its ability to deal with businesses 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 consideration will also be needed in designing the export platforms to ensure that they reduce restrictions on accessing the informal sector labor market, including the right to contract out work. The tendency to use physical customs, rather than accounting controls which 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 bode well for export platforms becoming the springboard for job creation in labor-intensive manufactures in the medium term.

To get the macroeconomic conditions right, there will need to be a shift a away from the high interest rates that have persisted since 1993. Over 1994–98, inflation-adjusted lending rates by commercial banks have been generally in the range of 15–30%. This lowering of interest 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—namely, lower real interest rates, weaker exchange rate, and lower wages in U.S. dollar terms—is combined with an increase in flexibility of export platforms and labor markets, as well as an effort to strengthen the economic infrastructure, then Kenya's export prospects in labor-intensive manufactures could brighten considerably.