

**TITLE: LEGAL IMPLICATIONS OF REGIONAL  
INTEGRATION INITIATIVES ON SPECIAL  
ECONOMIC ZONES IN KENYA**

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**A Mini Dissertation Submitted in Partial Fulfilment of the Requirements for the Degree  
of Master of Laws (LL.M) in International Trade and Investment Law in Africa**

## DECLARATION

I declare that this Mini-Dissertation which is hereby submitted for the award of Legum Magister (LL.M) in International Trade and Investment Law in Africa at International Development Law Unit, Centre for Human Rights, Faculty of Law, University of Pretoria, is my original work and it has not been previously submitted for the award of a degree at this or any other tertiary institution.

Signed

.....

Judith Rhoda Achieng Ogeda

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## **ABSTRACT**

Kenya has recently passed a Special Economic Zones law with the aim of providing a legal framework to enable the establishment of Special Economic Zones (SEZs) in the country. Given that the country is also an active member of several regional integration initiatives (of which the study focuses on the East African Community (EAC) in which Kenya is an integral member), this study investigates the legal framework governing SEZs at the national level and the regional level with a view to determine if there is any legal conflict between the two frameworks that may pose a challenge for Kenya in her decision to simultaneously pursue regional integration initiatives and Special Economic Zones development as trade and investment tools. In finding that there is no synergy between the regional integration arrangements in the EAC and SEZ programmes in member countries, this study makes a number of recommendations including that the region should harmonize the regulatory, incentives and strategic structures of SEZ programmes in the member countries.

## **LIST OF ABBREVIATION**

|          |  |
|----------|--|
| AU       | African Union  |
| EAC      | East African community   |
| EACCU    | East African Community Customs Union                                 |
| ECA      | Economic Commission for Africa                                       |
| EPA      | Economic Partnership Agreements                                      |
| EPZ      | Export Processing Zone   |
| EU       | European Union   |
| CACM     | Central American Common Market                                       |
| CARICOM  | Caribbean Community  |
| CET      | Common External Tariff   |
| C-FTA    | Continental Free Trade Agreement                                     |
| CIC      | Investment Climate Advisory Services                                 |
| COMESA   | Common Market for Eastern and Southern Africa                        |
| CU       | Customs Union  |
| FDI      | Foreign Direct Investment  |
| FIAS     | Facility of Investment Climate Advisory Services                     |
| FTA      | Free Trade Agreement   |
| GATS     | General Agreement for Trade in Services                              |
| GATT     | General Agreement for Trade and Tariffs                              |
| GSP      | Generalised Scheme of Preferences                                    |
| HIV/AIDS | Human Immunodeficiency Virus/<br>Acquired Immune Deficiency Syndrome |

|          |  |
|----------|--|
| ICT      | Information and Communication Technology           |
| IGAD     | Intergovernmental Authority on Development         |
| LAPSSET  | Lamu Port-South Sudan-Ethiopia-Transport           |
| MDG      | Millennium Development Goals                       |
| MERCOSUR | Mercado Común del Sur                              |
| MFN      | Most Favoured Nation                               |
| NAFTA    | North American Free Trade Agreement                |
| PTA      | Preferential Trade Agreement                       |
| RTA      | Regional Trade Agreement                           |
| SADC     | Southern African Development Community             |
| SEZ      | Special Economic Zone                              |
| T-FTA    | Tripartite Free Trade Agreement                    |
| UNCTAD   | United Nations conference on Trade and Development |
| UNECA    | United Nations Economic Commission for Africa      |
| UNIDO    | United Nations Industrial Development Organization |
| VAT      | Value Added Tax                                    |
| WCO      | World Customs Organization                         |
| WTO      | World Trade Organization                           |

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# CHAPTER 1

## 1 INTRODUCTION

### 1.1 Introduction

Kenya adopted an Export Processing Zones (EPZs) Programme in 1990 through the enactment of the Export Processing Zones Act.<sup>1</sup> By virtue of the Act, an Export Processing Zones Authority was established as the official regulatory body for the EPZ programme. The main objective for the adoption of the programme was to act as means through which the country could shift its economy from import substitution to export – led growth. The zone has been of benefit as a means to attract FDI, generate employment and diversify export production among other benefits. The investors in the EPZs have been granted several incentives including tax holidays, exemptions from customs duties on inputs, freedom from exchange controls among other incentives. However, the EPZ programme has had several challenges and shortcomings which have led the Ministry of Trade to review the programme and adopt a Special Economic Zones (SEZ) Policy with the intention of establishing a different structure for Special Economic Zones in the country.

The SEZ programme has been cited as one of the economic pillars of the Country's Vision 2030 Programme.<sup>2</sup> If successful, the programme has the potential of creating employment opportunities for thousands of Kenyan population who are currently unemployed, promoting export diversification and bringing in foreign direct investment among other benefits that successful SEZs have been associated with.

At the same time, Kenya is actively pursuing regional integration as one of its main tools of economic growth and development. The country is currently a member of the East African Community (EAC) as well as the Common Market for East and Southern Africa (COMESA). The combined use of both SEZs and Regional Trade Agreements (RTAs) as tools of economic growth and development is one which if properly handled can result in synergy of the two locking together their respective benefits to bring forth tremendous results.<sup>3</sup> On the other hand, the simultaneous use of the two initiatives can be faced with challenges which if not properly

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<sup>1</sup> Cap 517 Laws of Kenya.

<sup>2</sup> This is the country's development programme covering the period 2008 to 2030. It was launched on 10 June 2008 by President Mwai Kibaki.

<sup>3</sup> S Woolfrey *Special Economic Zones and Regional Integration in Africa* (2013) 17.

addressed within their respective regulatory frameworks may result in a conflict between them which may lead to their failure to fulfil intended objectives.

## **1.2 Research problem**

Kenya has just put in place a regulatory framework to govern Special Economic Zones. The Special Economic Zones Bill, 2015 was signed into law by President Uhuru Kenyatta on 11<sup>th</sup> September, 2015 and came into force on 15<sup>th</sup> December, 2015.

However, Kenya is a member of both COMESA and EAC regional trading blocs. The EAC is currently a Customs Union, the Protocol establishing the Customs Union having been signed on 2nd March, 2004 and entered into force on 1st January, 2005. COMESA, on the other hand, is a Free Trade Area but is working towards becoming a Customs Union. Currently, the member states of COMESA, SADC and the EAC have launched initiatives to form a Tripartite Free Trade Area (T-FTA) between them while at the same time; the African Union (AU) is pushing for the formation of a Continental Free Trade Area (C-FTA) to cover all its members.

Many critics are wary of concurrent use of SEZs and RTAs pointing out that the relationship between the two instruments is complex. They argue that RTAs affect the potential of their members to establish SEZs within them and changes, significantly, the business environment for the operations of SEZ enterprises. Similarly, the creation of SEZs in RTA member countries could also pose both challenges and potential synergy for regional integration initiatives.<sup>4</sup>

Various economic analysts have also discouraged the development by developing countries of SEZs due to their possible negative impacts on regional integration initiatives pursued by such countries.<sup>5</sup> Further, simultaneous pursuit of the two instruments for trade and investments have been argued to have a potential of creating significant problems for a developing country such as Kenya for the reason that RTAs and SEZs are driven by somewhat inconsistent economic rationales.<sup>6</sup> An example is where the use by countries of SEZ incentives to attract investors results in a “race to the bottom” between neighbouring countries thereby jeopardizing integration process. This is a very likely trend particularly in a region such as the East African Community where attracting foreign direct investment is generally considered a development imperative and where fiscal and other investment incentives are widely used to “compensate

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<sup>4</sup> S Woolfrey, Chapter 7, *Special Economic Zones and Regional Integration in Africa*, (2013) 122. Chapter in book Cape to Cairo: Exploring the Tripartite FTA Agenda <http://www.tralac.org/images/docs/5548/cape-to-cairo-4complete.pdf> 123.

<sup>5</sup> J Sargent & L Mathews *Combining Export Processing Zones and Regional Free Trade Agreements: Lessons from the Mexican Experience* (2001) 14 available at [www.elsevier.com/locate/worlddev](http://www.elsevier.com/locate/worlddev).

<sup>6</sup> S Woolfrey (n 4 above).

for the underlying competitiveness shortcomings of SEZs and the domestic economies” as a whole.<sup>7</sup>

This study will therefore seek to examine Kenya’s regulatory framework with regards to its setting up of SEZs and the implications that the existing regional trade arrangements (particularly the East African Community) that the country is a member in, will have on the SEZ initiatives. The study will also examine what measures, if any, the country and the regional bloc should put in place to ensure that both the SEZs and the Regional Trade Agreements are beneficial to the country and the regional economies as a whole.

### **1.3 Research question(s)**

The overarching question in this research is: What implications will Regional Trade Agreements that Kenya is party to have on her proposed implementation of Special Economic Zones (SEZ) programmes?

In answering this broad question, the following sub-questions will also be answered-

- i. What is the nature and context of SEZs and the various regional initiatives that Kenya is a member of?
- ii. What are the legal frameworks regulating Special Economic Zones in the country and at the regional level within the East African Community?
- iii. What are the legal implications of regional integration for SEZs in Kenya?
- iv. What should be the appropriate legal and regulatory approach by the East African Community to ensure synergy between SEZs and regional integration initiatives and the fulfilment of the intended objectives of the two instruments?

### **1.4 Thesis statement**

This study argues that RTAs and SEZs are both important trade and investment policy instruments for Kenya in that they both play a positive role of promoting industrialization and economic development for the country. Their simultaneous use by the country may however pose a challenge and there is therefore need to put in place proper legislative measures both at the national and regional level to ensure synergy between them so that the SEZ programme

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<sup>7</sup> N Koyama, Chapter 6, *SEZs in the Context of Regional Integration: Creating Synergies for Trade and Investment* (2011) 128. Chapter in book *Special Economic Zones: Progress, Emerging challenges and Future Directions*.

does not undermine the strides of regional integration already made in the East African Community.

### **1.5 Objectives and justification for the study**

Both Special Economic Zones and regional integration are important economic development tools for Kenya. The East African Community (EAC) has made great strides in integration and Kenya has been a key role player in ensuring the success of the community. This being the case and given the potential for conflict between SEZ programmes and RTAs, there is need for an evaluation of the proposed SEZ programme in Kenya to ensure that it does not in any way undermine the great strides already made by Kenya in regional integration.

Since RTAs and SEZs can only achieve their objectives of aiding in economic development of the country if they are in synergy, this research will be significant in making an evaluation of the two programmes to find out any areas of conflict and make recommendations for better policies should there be conflict. The research will also make an important contribution to currently available literature in this area of study.

This research is timely because the Special Economic Zones Act, 2015 is quite a new law given that it only came into effect on 15th December, 2015 and as such, very little if any analysis has been made on its compatibility with the country's regional integration initiatives. This research will therefore be an important source of information on this new law and its legal implications on regional integration.

### **1.6 Literature Review**

Very limited literature exists that give an in-depth analysis of the implications of combining SEZs and regional integration initiatives. Of the existing works, none has given an in-depth analysis of African SEZ in the context regional integration despite the proliferation of both SEZs and Regional Integration Arrangements in the continent. From the available literature though, one critical question that has been asked across the board has been the compatibility of SEZs and RTAs and whether there is justified economic rationales for combined use of the two initiatives. To answer this question, many authors have looked at the kind of legal and economic challenges a country (especially developing countries) is likely to face in applying the two initiatives simultaneously.

**Sean Woolfrey**<sup>8</sup> notes that establishment of Regional Trade Agreements (RTAs) affects the possibilities for zone creation within the members of such an RTA and significantly changes the trading environment of SEZ enterprises and operators.<sup>9</sup> While he agrees that the existence of SEZs in countries pursuing regional integration initiatives can pose challenges, he notes that the same has a potential to create synergies for such RTA initiatives.<sup>10</sup>

He also argues that SEZs and RTAs are driven by inconsistent rationales which can create great challenges for developing countries.<sup>11</sup> In his analysis he points to the fact that developing countries commonly use incentives to attract investments within their SEZs. As such, if neighbouring three neighbouring countries who are members of an RTA, all have their individual SEZs within their borders, they might end up competing for investors through use of incentives, a concept known as “a race to the bottom” thereby jeopardizing their regional integration initiatives.<sup>12</sup>

He also gives an example of a ‘prisoner’s dilemma’ scenario where neighbouring countries would benefit more if they would cooperate regionally to remove their competing incentives but because each of them wants to benefit individually by being seen to offer the best incentives, they act in their own self-interest.<sup>13</sup> Such incentive-bidding wars, he notes, partially negate the effectiveness of the said incentives resulting in the competing countries simply transferring rents to foreign investors.<sup>14</sup> Such incentive wars are unlikely to result in the region as a whole benefitting from higher levels of investments but instead may lead to tensions between neighbouring countries thereby compromising regional integration efforts.<sup>15</sup>

**Naoko Koyama**<sup>16</sup> argues that when the two initiatives are used simultaneously, they have the potential to generate significant synergies.<sup>17</sup> He however, states that RTAs often face

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<sup>8</sup> S Woolfrey, (n 4 above).

<sup>9</sup> S Woolfrey, (n 4 above).

<sup>10</sup> S Woolfrey (n 4 above) 122.

<sup>11</sup> S Woolfrey (n 4 above) 122.

<sup>12</sup> S Woolfrey (n 4 above) 122.

<sup>13</sup> S Woolfrey, Chapter 7, *Special Economic Zones and Regional Integration in Africa*, (2013) 122. Chapter in book *Cape to Cairo: Exploring the Tripartite FTA Agenda* <http://www.tralac.org/images/docs/5548/cape-to-cairo-4complete.pdf> 123.

<sup>14</sup> S Woolfrey (n 4 above) 123.

<sup>15</sup> S Woolfrey (n 4 above) 123.

<sup>16</sup> N Koyama, Chapter 6, *SEZs in the Context of Regional Integration: Creating Synergies for Trade and Investment* (2011) 128. Chapter in book *Special Economic Zones: Progress, Emerging challenges and Future Directions*.

<sup>17</sup> N Koyama, Chapter 6, *SEZs in the Context of Regional Integration: Creating Synergies for Trade and Investment* (2011) 128. Chapter in book *Special Economic Zones: Progress, Emerging challenges and Future Directions*

challenges in incorporating SEZs in their regulatory frameworks based on the fact that while RTAs represent bilateral or multilateral instruments, SEZ on the other hand are instrument by which an individual promotes investments and exports hence potentially competing with their RTA partners.<sup>18</sup>

He also notes several challenges that may arise including “tariff jumping” whereby a foreign investor may jump over the tariff wall to avoid trade costs related to tariffs.<sup>19</sup> Similarly, because many SEZs allow duty free entry of inputs from outside the RTA, there is a potential of goods entering the RTA free of duty through the SEZ and then leak into the customs territory of other RTA members.<sup>20</sup> While excluding SEZ investors from taking advantage of the regional market can be a way of minimizing tariff jumping and related challenges, **Koyama** is of the view that it could prevent member countries from realizing the true potential of these two trade and investment policy tools and achieving effective regional integration.<sup>21</sup> He concludes that to fully leverage both of these policy tools, RTA member countries need to take a collaborative approach to harmonize their SEZ programs.<sup>22</sup>

In his analysis of Export Processing Zones (EPZs) and other special zones in the Latin America, **Jaime Granados**<sup>23</sup> suggests that a wind of change is blowing and that some elements of EPZs will be left behind either because they represent a real and potential distortion to international trade or investment flows or because they are incompatible with trade agreements that establish free trade areas or customs unions.<sup>24</sup> He analyses how regional trade arrangements in the Latin America treat special zones in their agreements and notes that in some like MERCOSUR, CARICOM and the CACM, it was agreed not to grant preferential treatment stipulated in their regional agreements to goods produced under special regimes.<sup>25</sup> Thus goods from special zones pay the normal import tariff if they are to enter the regional market. The overall trend in his analysis is that countries have concerns about importing goods produced under special regimes from their regional trade partners.<sup>26</sup>

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<sup>18</sup> N Koyama (n 16 above) 128.

<sup>19</sup> N Koyama (n 16 above) 128.

<sup>20</sup> N Koyama (n 16 above) 129.

<sup>21</sup> N Koyama (n 16 above) 128.

<sup>22</sup> N Koyama (n 16 above) 128.

<sup>23</sup> J Granados *Export Processing Zones and Other Special Regimes in the Context of Multilateral and Regional Trade Negotiations* (2003) 2 available in pdf. Format at [www.iadb.org/intal](http://www.iadb.org/intal) or [www.iadb.org/int](http://www.iadb.org/int).

<sup>24</sup> J Granados *Export Processing Zones and Other Special Regimes in the Context of Multilateral and Regional Trade Negotiations* (2003) 2 available in pdf. Format at [www.iadb.org/intal](http://www.iadb.org/intal) or [www.iadb.org/int](http://www.iadb.org/int).

<sup>25</sup> J Granados (n 23 above) 6.

<sup>26</sup> J Granados (n 23 above) 6.

The reason for such apprehension, **Granados** notes, includes the potential of trade deflection and lack of competitiveness of local producers. If goods produced under subsidized conditions in special regimes are allowed to enter the local or regional market duty free, they would place local producers at a disadvantage vis a vis special zones producers.<sup>27</sup> He further notes that restrictive measures on treatment of special zones in regional trade agreements might contrary to general perception, serve to attract foreign direct investment.<sup>28</sup> This, he explains, is because such measures would compel extra-regional suppliers who formerly supplied inputs to special zones producers to relocate to the country where the special zone is located because if they do not relocate they would have to pay import tariff and taxes in order to sell to the special zones producers.<sup>29</sup>

**John Sargent and Linda Mathews**<sup>30</sup> also argue that Special Economic Zones and Regional Trade Agreements are driven by inconsistent economic rationales.<sup>31</sup> In their analysis of the challenges faced by the North American experiment in combining a major Export Processing Zone (EPZ) (Mexico's *Maquiladoras*), within the terms of a Free Trade Agreement (the North American Free Trade Agreement (NAFTA)), they conclude that unless developing countries are fully committed to competing in a global (rather than a regional) economy; policy makers in such countries should think twice about attempting to combine special zones with their regional integration initiatives.<sup>32</sup>

The literature discussed above provides a general analysis of potential challenges that are likely to be faced by countries seeking to use both Special economic Zones and regional integration initiatives in their trade and investment policy instruments. **Jaime Granados** and **John Sargent and Linda Mathews** make their analysis of such challenges in respect of regional integration and special zones in the Latin America and the North America respectively. This research will however take a Kenyan perspective in that it will make an analysis of Kenya's Special Economic Zones and the challenges the country might face in her attempt to effect simultaneous use of SEZs and regional integration initiatives.

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<sup>27</sup> J Granados (n 23 above) 10.

<sup>28</sup> J Granados (n 23 above) 10.

<sup>29</sup> J Granados (n 23 above) 10.

<sup>30</sup> J Sargent & L Mathews *Combining Export Processing Zones and Regional Free Trade Agreements: Lessons from the Mexican Experience* (2001) 1 available at [www.elsevier.com/locate/worlddev](http://www.elsevier.com/locate/worlddev).

<sup>31</sup> J Sargent & L Mathews *Combining Export Processing Zones and Regional Free Trade Agreements: Lessons from the Mexican Experience* (2001) 1 available at [www.elsevier.com/locate/worlddev](http://www.elsevier.com/locate/worlddev).

<sup>32</sup> J Sargent & L Mathews (n 29 above) 14.

This research therefore departs from existing literature in that it seeks to shed light on the legal implications of Kenya's newly enacted Special Economic Zones Act, 2015 on the country's regional integration initiatives particularly within the East African Community (EAC) as well as the Common Market for Eastern and Southern Africa (COMESA). This is an area that has not been explored and this research will therefore be resourceful in providing information on the issue and in filling the existing gap in this area.

### **1.7 Research methodology**

Essentially, the study will be desk-top and library based. The author will also use analytical, descriptive and prescriptive methods in presenting this research. The analytical method will be used to present an overview of the current and proposed legislative and regulatory framework for SEZs in Kenya and the East African Community while the descriptive method will be used to evaluate some of the legal and economic conflicts that may arise in Kenya's attempt to use both SEZs and regional integration as trade and investment policy instruments. The author then uses prescriptive method to make recommendations for necessary legal provisions and harmonization requirements that will ensure synergy between regional integration initiatives and the proposed SEZ program.

In making recommendations, the author shall use comparative analysis to determine what kind of legal provisions have worked in other jurisdictions such as Mexico within the context of North American Free Trade Agreement (NAFTA)

### **1.8 Overview of chapters**

Chapter one of this study discusses the introductory matters which include articulation of the research problem, formulation of research questions and the thesis statements among others.

In chapter two, the nature and context of SEZs is examined in general after which the legal and regulatory framework for SEZs in Kenya is analysed.

Chapter 3 looks at the concept of regional integration, its regulatory framework, rationales as well as the advantages that a country pursuing regional integration has to gain. The chapter then examines the various regional initiatives and bodies that Kenya is a member of with particular emphasis on the East African Community (the EAC).

Chapter 4 brings together the concepts of SEZs and RTAs examining how the two instruments relate with each other, the potential legal and economic challenges a country employing the two instruments simultaneously may face and the legal approaches that have been taken by

some countries to mitigate such challenges. The chapter further examines the regulatory framework for SEZs in the context of regional integration within the East African Community Customs Union as well as at the national level in Kenya with a view to identifying any points of conflicts and if there is synergy between the SEZ programmes and regional integration initiatives undertaken by the country.

In chapter 5, a case for regional harmonization of SEZ programmes within the East African Community is made. A harmonization that goes beyond regulatory and tariff issues is recommended. The appropriate legal and regulatory approach to ensuring synergy between SEZs and RTAs in the EAC is further discussed.

Lastly, in chapter 6, the conclusions are drawn and recommendations made.

## CHAPTER 2

### 2 THE CONCEPT OF SPECIAL ECONOMIC ZONE (SEZ) AND ITS LEGAL FRAMEWORK

#### 2.1 Introduction

This chapter looks into the concept of Special Economic Zones (SEZs), its definition, characteristics, types and the rationale behind zone development. The chapter goes a step further to introduce the legal framework for SEZs in Kenya by first looking at a short history of zones in Kenya and then analysing some provisions of the newly enacted Special Economic Zones Act, 2015.

#### 2.2 Defining Special Economic Zones

Given their heterogeneous nature,<sup>33</sup> defining what constitutes a Special Economic Zone is not an easy task. This is mainly due to the different ways in which the concept of Special Economic Zones has been operationalized.<sup>34</sup> The Revised Kyoto Convention of the World Customs Organization (WCO) defines SEZs as parts of the territory in a country where imported goods and products are introduced tax and duty free because these areas are deemed to be outside the customs territory of that country.<sup>35</sup>

Another attempt at defining a Special economic zone describes it as a delineated area within a country's national borders where business regulations are more relaxed than those prevailing in the other parts of the country (national territory).<sup>36</sup> A common characteristic of these zones is that the rules governing the activities of stakeholders within them tend to be more liberal than those outside their borders.<sup>37</sup> In fact, SEZ maintain their own uniquely flexible regulatory framework relating to matters such as taxation, land ownership, labour regulations, investment conditions, and trade and customs administration.<sup>38</sup>

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<sup>33</sup> T Farole *Special Economic Zones: What have we learned?* (2011) 1  
<http://siteresources.worldbank.org/INTPREMNET/Resources/EP64.pdf> accessed on 15th February, 2016.

<sup>34</sup> FIAS *Special Economic Zones, performance, lessons learned and implications for zone development* (2008) 18.

<sup>35</sup> Annex D to the International Convention on the Harmonization and Simplification of Customs (revised in 1999).

<sup>36</sup> FIAS (n 34 above) 9.

<sup>37</sup> T Farole *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience* (2011) 24.

<sup>38</sup> Farole (n 37 above)24.

It would however be safe to point out that the term “Special Economic Zones (SEZ)” is a generic term used as a common denomination for various models of economic programmes whose characteristics and features differ depending modes of operation and activities allowed or operated within them.<sup>39</sup> As such, one single definition cannot fully cover or describe all types of economic zones given their diverse and variant modes of operation.

### 2.3 Common characteristics of SEZs

Although SEZs exhibit different modes of operation and implementation, there are some general fundamental principles that underpin their concept and that are shared by most of the different types of zones<sup>40</sup>. FIAS 2008 outlines four fundamental features which characterize an SEZ:

- i. Geographically delimited area, usually fenced-in<sup>41</sup> - they are usually delimited portions of the national territory forming legal spaces which provide for a set of more liberal and administratively efficient trade, investment and operating rules than those prevailing in the rest of the national territory.<sup>42</sup> It is however worth nothing that some countries have now done away with this geographic spatiality of zones and have instead made them purely legal spaces which apply across the entire national territory or large portions of the national territory.<sup>43</sup>
- ii. Run under a single management/administration – the administration of regulatory regime of a zone requires a dedicated governance structure which can either be centralized or decentralized.<sup>44</sup> The nature of the governance structure however varies depending on type of zone regime, the number of the zones, the prevalent administrative culture as well as the role of the private sector in the development and operation of the zones.<sup>45</sup> The ultimate goal of the administration structure is to ensure efficient management of the regime and ensure that investors benefit from its provisions.<sup>46</sup>
- iii. Eligibility for benefits based upon physical location within the zone<sup>47</sup>

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<sup>39</sup> Farole (n 37 above) 16.

<sup>40</sup> FIAS (n 34 above) 9.

<sup>41</sup> This is with the exception of the single factory zones which do not have to be in a specific zone/location.

<sup>42</sup> Farole (n 37 above)24.

<sup>43</sup> Farole (n 37 above)24.

<sup>44</sup> Farole (n 37 above)24.

<sup>45</sup> Farole (n 37 above)24.

<sup>46</sup> Farole (n 37 above)24.

<sup>47</sup> Again with the exception of single factory zones.

- iv. Separate customs area with special incentives, regulatory regime and streamlined procedures – the key feature of an economic zone is that it benefits from a different regulatory regime from that in the rest of the economy.<sup>48</sup>

## **2.4 Types of Zones**

As already mentioned, “Special Economic Zones” is a generic term used to describe different types of economic zones with varying modes of operation.<sup>49</sup> As such different types of zones fall within the definition of SEZs. The following are some of such zones:

### **2.4.1 Free Ports**

Free ports are generally meant to facilitate exports and imports and accommodate all types of activities, including tourism and retail sales and provide a broader set of benefits and incentives.<sup>50</sup> They are usually in or near major international transport nodes and are usually indirectly or directly under the administration of ports.<sup>51</sup> They typically encompass much larger areas such as international airports, sections of cities and sometimes even whole countries.<sup>52</sup> They may also permit on-site residence.<sup>53</sup>

### **2.4.2 Free Trade Zones**

These are the oldest form of SEZs.<sup>54</sup> Free Trade zones are also referred to as commercial free zones.<sup>55</sup> They are fenced-in, duty-free areas, offering trade, trans-shipment, storage and re-export operations facilities such as ware-housing, storage, and distribution.<sup>56</sup> They are located around ports of entry such as airports in many countries.

### **2.4.3 Export processing zones (EPZs)**

EPZs are fenced-in industrial estates specializing in manufacturing for exports that offer firms free trade conditions and a liberal regulatory environment.<sup>57</sup> They give special incentives and

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<sup>48</sup> Farole (n 37 above) 24.

<sup>49</sup> FIAS (n 34 above) 9.

<sup>50</sup> FIAS (n 34 above) 10.

<sup>51</sup> Farole (n 37 above)29.

<sup>52</sup> Farole (n 36 above)29.

<sup>53</sup> FIAS (n 34 above) 10.

<sup>54</sup> Farole (n 37 above)27.

<sup>55</sup> FIAS (n 34 above) 10.

<sup>56</sup> FIAS (n 34 above) 10.

<sup>57</sup> D Madani *A review of the role and impact of Export Processing Zones* (1999) 5.

facilities for manufacturing and related activities mostly targeting export markets<sup>58</sup>. Some of the incentives offered in EPZs include unlimited, duty-free imports of raw, intermediate input and capital goods necessary for the production of exports; less governmental red-tape; more flexibility with labour laws for the firms in the zone than in the domestic market; generous and long-term tax holidays and concessions to the firms; and better infrastructure and communications services.<sup>59</sup>

#### **2.4.4 Enterprise zones**

Enterprise zones are aimed at revitalizing distressed urban or rural areas through the provision of tax incentives and financial grants.<sup>60</sup> They are also targeted at increasing private sector participation.<sup>61</sup> Enterprise zones do not allow duty free imports but may provide license exceptions and zoning relief tax payment.<sup>62</sup> Activities conducted in enterprise zones include manufacturing, trade and related commercial activities.<sup>63</sup>

#### **2.4.5 Single Factory zones**

These are schemes which provide incentives to individual factories regardless of their location. Individual enterprises are provided with zone status and allowed to locate anywhere on the national territory or a designated part of the territory.<sup>64</sup> Factories benefitting from such schemes do not have to be located within a designated area to receive incentives.<sup>65</sup>

#### **2.4.6 Specialized zones**

These are zones which are mostly intended to promote activities related to science and technology sectors. They include science/technology parks, petrochemical zones, logistics parks, airport-based zones, and information technology and service parks.<sup>66</sup>

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<sup>58</sup> Madani (n 57 above).

<sup>59</sup> Madani (n 57 above).

<sup>60</sup> FIAS (n 34 above) 11.

<sup>61</sup> A Palit & S Bhattacharjee *Special Economic Zones in India: Myths and Realities* (2008) 5.

<sup>62</sup> A Palit & S Bhattacharjee (n 61 above) 6.

<sup>63</sup> A Palit & S Bhattacharjee (n 61 above) 7.

<sup>64</sup> Farole (n 37 above) 28.

<sup>65</sup> FIAS (n 34 above) 11.

<sup>66</sup> FIAS (n 34 above) 11 and 12.

## 2.5 Rationale for zone development

The rationale for a country establishing SEZs varies depending on whether the country is a developing country or a developed one.<sup>67</sup> While for most developed countries, the principle rationale behind SEZ programs is enhancing trade efficiency and manufacturing competitiveness, according to Madani<sup>68</sup> two considerations traditionally underlie development of zones in developing countries. The two are policy and infrastructure considerations.<sup>69</sup>

### 2.5.1 Policy considerations

According to Farole, zones exist because of the social values or return they are expected to generate (policy raison d'être).<sup>70</sup> Accordingly, they are established to generate or contribute in the economic transformation of their host economies in a more effective or faster way than would be the case had they not been in existence.<sup>71</sup> As such, the main policy consideration behind zone development is to act as catalysts for economic growth.<sup>72</sup> The mode of implementing or achieving this objective however varies from country to country but the 2008 FIAS report lists four specific policy considerations underlying zone development. They are:<sup>73</sup>

#### *In support of a wider economic reform strategy*

Zones can be used as a simple tool allowing a country to develop and diversify exports. Zones such as EPZs can be employed as a way of reducing anti-export bias while keeping protective barriers intact.<sup>74</sup> SEZs are also capable of contributing to export development both through accelerating export growth and export diversification.<sup>75</sup> This is of great importance particularly to poorer developing countries that rely heavily on the export of primary commodities.

According to a World Bank study<sup>76</sup> however, SEZs should not be used by developing countries to “muddle along without reforms” but rather as a supplement to countrywide reforms as opposed to creating isolated free market enclaves.<sup>77</sup>

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<sup>67</sup> FIAS (n 34 above) 12

<sup>68</sup> Madani (n 57 above) 6

<sup>69</sup> FIAS (n 34 above) 12

<sup>70</sup> Farole (n 37 above) 25

<sup>71</sup> Farole (n 37 above) 25

<sup>72</sup> Farole (n 37 above) 25

<sup>73</sup> Madani (n 57 above)

<sup>74</sup> Farole (n 37 above) 26

<sup>75</sup> Farole (n 37 above) 25

<sup>76</sup> FIAS (n 34 above) 4 quoting a 1992 World Bank Study

<sup>77</sup> FIAS (n 34 above) 4

### *To serve as “pressure valves” to alleviate growing unemployment*

One of the key objectives for zone development is employment generation.<sup>78</sup> Special Economic Zones are viewed as highly effective tools for job generation, particularly for women entering the workforce.<sup>79</sup> To smaller countries with small populations especially, zones become a much more significant source of employment for a large portion of the population.<sup>80</sup> Examples of such countries are Mauritius and the Seychelles.<sup>81</sup>

According to a study, zones account for approximately \$200 billion in gross exports per annum and directly employ over 40 million workers and 60 million workers indirectly.<sup>82</sup> The impact of these jobs in countries with high rates of unemployment and underemployment are therefore significant.<sup>83</sup>

### *As experimental laboratories for the application of new policies and approaches*

Zones can be a useful tool for a government to experiment new policies before rolling them out to the wider economy. China for example used its free-ports to introduce and test first its financial, legal, labour, and even pricing policies before being extended to the rest of the economy.<sup>84</sup>

### *To attract foreign direct investment*

Most new SEZ programs, particularly in most developing countries are designed to attract foreign investment.<sup>85</sup> If well implemented, zones can play an important role in attracting foreign direct investment, offsetting some aspects of an adverse investment climate by offering better facilities and best practice policies.<sup>86</sup>

## **2.5.2 Infrastructure rationale**

The “hardware” of special economic zones which usually comprise of fully serviced sites with purpose-built facilities for sale or lease, is intended to enhance the competitiveness of

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<sup>78</sup> FIAS (n 34 above) 34

<sup>79</sup> FIAS (n 34 above) 34

<sup>80</sup> Madani (n 57 above) 37

<sup>81</sup> FIAS (n 34 above) 12

<sup>82</sup> FIAS (n 34 above) 34

<sup>83</sup> Madani (n 57 above) 37

<sup>84</sup> FIAS (n 34 above) 12

<sup>85</sup> Farole (n 37 above) 25

<sup>86</sup> FIAS (n 34 above) 35

manufacturers and service providers within the zones.<sup>87</sup> It is also aimed at realizing agglomeration benefits such as efficiencies in government supervision of enterprises, provision of off-site infrastructure, improved environmental controls, and increased supply and sub-contracting relationships among industries, which arise from these industries being concentrated in one geographical area.<sup>88</sup>

Infrastructure considerations are therefore an important driving force behind zone development in countries with poor infrastructure.<sup>89</sup>

## **2.6 Zone benefits**

Two main types of benefits are associated with zone development.<sup>90</sup> These benefits can be achieved in the short and long term respectively.<sup>91</sup>

### **2.6.1 Static economic benefits**

These are attained in a relatively short term through the use of the economic zone as a policy instrument of trade and investment.<sup>92</sup> They arise as a result of attaining exchange and specialization gains and include job creation, generation of foreign exchange through exports, as well as creation of economic value added.<sup>93</sup>

### **2.6.2 Dynamic economic benefits**

These are the longer term developmental and structural benefits derived from zone development.<sup>94</sup> They may include soft and hard technology transfers; promotion of non-traditional economic activities; promotion of domestic entrepreneurialism and encouragement of economic openness.<sup>95</sup> Economic zones may also be established with the goal of effecting positive change in the competitiveness of the country or region.<sup>96</sup>

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<sup>87</sup> FIAS (n 34 above) 12

<sup>88</sup> FIAS (n 34 above) 12

<sup>89</sup> FIAS (n 34 above) 12

<sup>90</sup> Farole (n 37 above) 26

<sup>91</sup> Farole (n 37 above) 26

<sup>92</sup> Farole (n 37 above) 26

<sup>93</sup> Farole (n 37 above) 26

<sup>94</sup> Farole (n 37 above) 26

<sup>95</sup> Farole (n 37 above) 26

<sup>96</sup> Farole (n 37 above) 26

## 2.7 Special Economic Zones in Kenya

### 2.7.1 From Export Processing Zones to Special Economic Zones

Kenya's history with economic zones dates back to 1990 when the country adopted an Export Processing Zones Program through the enactment of the Export Processing Zone (Cap 517 Laws of Kenya). The Act also established the Export Processing Zones Authority as the official regulatory body for the Program. The main objective for the adoption of the program was "to shift the economy from import substitution to export – led growth" through promoting and increasing the manufacture of goods or provision of services for export only.<sup>97</sup> The zones have been used to attract FDI, generate employment and diversify export production among other benefits and are listed among the few which are a bit successful in the Sub-Saharan region of Africa.<sup>98</sup>

Farole<sup>99</sup> in quoting FIAS (2008) states that nearly half of all Special Economic Zones in Sub-Saharan Africa are in Kenya most of which are single factory units licensed as Export Processing Zones' developers. Majority of these developers, although authorised to develop land and facilities for other EPZ operators as well, only carry out their own operations and are not industrial parks.<sup>100</sup>

Under the EPZ program, investors have been granted several incentives including tax holidays such as 10-year corporate tax holiday and 25 per cent tax thereafter, 10-year withholding tax holidays and stamp duty exemption.<sup>101</sup> Further, they are given 100 per cent investment deduction on initial investment applied over 20 years and VAT exemption on industrial inputs.<sup>102</sup>

Despite the above accolades, The EPZ programs have had several challenges and shortcomings and have reportedly not proven their worth to the government over the years amid concerns that their operations have failed to add meaningful economic value despite numerous tax

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<sup>97</sup> Ernst & Young Global Tax Alert: Kenya enacts Special Economic Zones Act, 2015 (4 December 2015) available

<sup>98</sup> Farole (n 37 above) 69

<sup>99</sup> Farole (n 37 above) 68

<sup>100</sup> Farole (n 37 above) 69

<sup>101</sup> Ministry of Industry, Investment and Trade: *Kenya to Roll out Special Economic Zones in First Quarter of 2016* <http://www.industrialization.go.ke/index.php/media-center/blog/310-kenya-to-roll-out-special-economic-zones-in-first-quarter-of-2016> accessed on February 28, 2016

<sup>102</sup> Ministry of Industry, Investment and Trade (n 101 above)

incentives.<sup>103</sup> Such concerns have led the Ministry of Industry Investment and Trade to review the program and adopt a Policy with the intention of establishing a new model of Special Economic Zones (SEZs) to operate on a new leaf different from the EPZ program.<sup>104</sup> As such, the government now plans to freeze new investments within the existing Export Processing Zones (EPZ) before the end of the year 2016 as it takes up the new model of SEZs.<sup>105</sup> What this means is that no new licenses will be granted under the EPZ program and at the expiry of their contractual period, existing investors in the EPZs will have a choice to either relocate or re-apply afresh to be considered for investments in the SEZs under stringent conditions<sup>106</sup>.

A notable difference between the operations of EPZs and that of SEZs is in the authorized activities within the delineated zones. While under Export Processing Zones Act (EPZ Act) the authorised activities in EPZ enterprises are manufacturing, commercial and services,<sup>107</sup> the Special Economic Zones Act, 2015 provides a non-exhaustive list of activities that can be operated within an SEZ.<sup>108</sup> The activities include but not limited to business processing, outsourcing, manufacturing and processing; livestock marshalling and inspection, refrigeration, deboning, value addition; and services and activities to facilitate tourism and recreation sector.<sup>109</sup>

The new SEZ program has been hailed as a significant step in Kenya's efforts to attract greater foreign direct investment with a great potential of enhancing economic growth through job creation.<sup>110</sup> The zones are expected to help investors cut down on key cost drivers such as transport, with the hope that surplus funds would go towards value addition thereby leading to export growth and diversification.<sup>111</sup> The focus of the new policy on SEZs is that goods are manufactured closer to sources of raw materials and investors are given preferential terms on matters such as licensing and business regulations to help boost Kenya's investment profile.<sup>112</sup>

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<sup>103</sup> Ministry of Industry, Investment and Trade (n 101 above)

<sup>104</sup> Ernst & Young (n 96 above)

<sup>105</sup> Ministry of Industry, Investment and Trade (n 101 above)

<sup>106</sup> Ministry of Industry, Investment and Trade (n 101 above)

<sup>107</sup> Farole (n 37 above) 70

<sup>108</sup> Special Economic Zones Act, Section 8

<sup>109</sup> Special Economic Zones Act, Section 8

<sup>110</sup> How special economic zones law alters enterprise horizon *The Business Daily* November 9, 2015 available at <http://www.businessdailyafrica.com/Opinion-and-Analysis/How-special-economic-zones-law-alters-enterprise-horizon/-/539548/2949718/-/uy2t4v/-/index.html> accessed on February 29, 2015

<sup>111</sup> Ministry of Industry, Investment and Trade (n 101 above)

<sup>112</sup> Ministry of Industry, Investment and Trade (n 101 above)

The SEZ project is currently being carried out on a pilot basis in the towns of Mombasa, Lamu and Kisumu.<sup>113</sup>

### **2.7.2 The Special Economic Zones Act, 2015**

President Uhuru Kenyatta signed into law the Special Economic Zones Act, 2015 (the Act) on 11th September, 2015. The Act which came into force on 15th December, 2015 makes provisions for the establishment of Special Economic Zones in the country<sup>114</sup>. The Act defines a Special Economic Zone as “...a designated geographical area where business enabling policies, integrated land uses and sector-appropriate on-site and offsite infrastructure and utilities shall be provided, or which has the potential to be developed, whether on a public, private or public-private partnership basis, where any goods introduced and specified services provided are regarded, in so far as import duties and taxes are concerned, as being outside the customs territory and wherein the benefits provided under the Act apply.”<sup>115</sup>

A customs territory is defined in the Act to mean the geographical area of the Republic of Kenya which does form part of a Special Economic Zone.<sup>116</sup> As such an SEZ is, for purposes of customs duties and taxes, considered as being outside of the Republic of Kenya.

The Act<sup>117</sup> establishes the Special Economic Zones Authority (the ‘Authority’) with among others, the responsibility of implementing the policies and programs of the government with regard to special economic zones.<sup>118</sup>

#### ***Types of Zones under the Act***

The Act<sup>119</sup> gives the Cabinet Secretary in charge of Industry Investment and Trade, on the recommendation of the Authority, the power to declare by Gazette Notice any area as a SEZ and designate it as any of the following zones:

- i. business service park - defined as a special economic zone to facilitate the provision of services including but not limited to regional headquarters, business processing

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<sup>113</sup> Ministry of Industry, Investment and Trade (n 101 above)

<sup>114</sup> Special Economic Zones Act, Section 3 (a)

<sup>115</sup> Special Economic Zones Act, Section 4 (4)

<sup>116</sup> Special Economic Zones Act, Section 2

<sup>117</sup> Special Economic Zones Act, Section 10 (1)

<sup>118</sup> Special Economic Zones Act, Section 11 (a)

<sup>119</sup> Special Economic Zones Act, Section 4 (1)

outsourcing centres, call centres, shared service centres, management consulting and advisory services and other associated services;<sup>120</sup>

- ii. Freeport zone - defined as a designated area placed at the disposal of the Authority where goods introduced into the designated area are generally regarded, in so far as import duties are concerned, as being outside the customs territory;<sup>121</sup>
- iii. free trade zone - defined as a customs controlled area where goods are off-loaded for trans-shipment, storage and may include bulk breaking, repacking, sorting, mixing, trading or other forms of handling but excluding manufacturing and processing;<sup>122</sup>
- iv. industrial park defined as a special economic zone with integrated infrastructure to facilitate the needs of manufacturing and processing industries;<sup>123</sup>
- v. information communication technology park defined to mean a special economic zone to facilitate the information communication technology sector, its services and associated activities;<sup>124</sup>
- vi. science and technology park defined as a special economic zone to facilitate the science and technology sector, its services and its associated activities;<sup>125</sup> and
- vii. tourist and recreation centre defined as a special economic zone to facilitate tourism and recreation sector, its services and associated activities.

### ***Incentives under the Act***

To make them as special as their name suggests, firms operating within the special economic zones will enjoy several incentives and benefits. Section 35 (1) of the Act exempts all licensed special economic zone enterprises, developers and operators from all existing taxes and duties payable under all domestic tax legislations including the East African Community Customs Management Act and Value Added Tax Act on all special economic zone transactions.

This provision has however since been amended by the Finance Act, 2015 whose provisions appear to limit the tax incentives by amending the Income Tax Act and the Value Added Tax (VAT). The limitations are to the effect that SEZ enterprises, developers and operators will be subjected to reduced corporate tax of 10% for the first 10 years of operation and 15% for the

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<sup>120</sup> Special Economic Zones Act, Section 2

<sup>121</sup> Special Economic Zones Act, Section 2

<sup>122</sup> Special Economic Zones Act, Section 2

<sup>123</sup> Special Economic Zones Act, Section 2

<sup>124</sup> Special Economic Zones Act, Section 2

<sup>125</sup> Special Economic Zones Act, Section 2

next 10 years.<sup>126</sup> Similarly, withholding tax on professional services and interest (other than dividends) by a SEZ enterprise, developer and operator to non-residents will apply at 10%.

In effect, the above provisions of the Finance Act, 2015 appear to be inconsistent with the SEZ Act which offers unlimited exemption on all taxes. It would be proper for there to be clarity on such issues before the program takes full effect and enterprises, operators and developers issued with licenses.

Further to the tax holidays and exemptions, the Act exempts licensed SEZ enterprises, developers and operators from stamp duty on the execution of any instrument relating to their business activities.<sup>127</sup> Additionally, SEZ enterprises, operators and developers are granted exemptions from certain business certificates, licenses, approvals and other requirements under several domestic national and local government laws.<sup>128</sup>

Licensed special economic zone enterprises, developers and operators under the Act are also entitled to work permits of up to twenty per cent of their full-time employees.<sup>129</sup> Additional work permits may however be given to specialized sectors on the recommendation of the Authority.<sup>130</sup>

Further, licensed enterprises within the SEZs will enjoy certain rights and protections such as, profit and capital repatriation, the full protection of their property rights against all risks of nationalization or expropriation and industrial and intellectual property rights among others.<sup>131</sup>

## **2.8 Conclusion**

SEZs have historically been used in many countries as trade and investment instruments to spur economic growth. Kenya has not been left behind in this quest for economic transformation and has sought to attain the benefits associated with these economic zones initially through the establishment of export processing zones and now through the yet to be implemented special economic zones programme.

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<sup>126</sup> Finance Act, 2015

<sup>127</sup> Special Economic Zones Act, Section 35 (2)(a)

<sup>128</sup> Special Economic Zones Act, Section 35 (2) (b) – (m)

<sup>129</sup> Special Economic Zones Act, Section 35 (3)

<sup>130</sup> Special Economic Zones Act, Section 35 (4)

<sup>131</sup> Ernst & Young (n 97 above)

As has been the case in many countries, it is hoped that this programme will be a successful one and that it will help the country achieve some of its goals such as creation of employment for the thousands of youths who are currently unemployed, attraction of foreign direct investment (FDI), transfer of technology to name just a few. The programme has been cited as one of the flagship projects under the economic pillar of Kenya's Vision 2030<sup>132</sup> and the enactment of the SEZ Act seen as an act to reaffirm to investors that Kenya is still on the path towards achieving its vision 2030.<sup>133</sup>

The SEZ programme is therefore in the spirit of inspiring foreign direct investment and positioning Kenya as a prominent business hub in the region and has been widely publicized as a significant step in Kenya's efforts to attract greater foreign investment.<sup>134</sup>

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<sup>132</sup> Ernst & Young (n 97 above)

<sup>133</sup> Ernst & Young (n 97 above)

<sup>134</sup> 'How Special Economic Zones law alters enterprise horizon' *Business Daily* November 9, 2015 available at <http://www.businessdailyafrica.com/Opinion-and-Analysis/How-special-economic-zones-law-alters-enterprise-horizon/-/539548/2949718/-/uy2t4v/-/index.html> accessed on February 28, 2015

## CHAPTER 3

### 3 REGIONAL TRADE AGREEMENTS (RTAs)

#### 3.1 Introduction

Having discussed the concept of SEZs in the previous chapter, this chapter introduces and defines the concept of regional integration, its legal framework and the various forms regional integration arrangements take. The rationale for regional integration is also examined at length. The chapter further discusses two regional bodies that Kenya is a member in, that is, the East African Community (EAC) and the Common Market for Eastern and Southern Africa (COMESA). Further, the role of Kenya in regional integration specifically in the EAC is examined.

#### 3.2 Regional integration defined

The Dictionary for Trade Policy Terms<sup>135</sup> describes regionalism as actions by governments to liberalize or facilitate trade on a regional basis, sometimes through free-trade areas or customs unions.<sup>136</sup> Free Trade Areas (FTAs) and Customs Unions are collectively referred to as Regional Trade Arrangements/Agreements (RTAs).<sup>137</sup> RTAs are therefore reciprocal trade agreements between countries/states which allow for trade preferences between and among the member states.

In the African context, regional integration has been seen as a critical strategy to address challenges posed by small domestic markets, limited economies of scale and marginalization of African economies in world trade.<sup>138</sup>

#### 3.3 Legal Framework for RTAs

The legal framework allowing for establishment of regional trade agreements within the WTO framework is Article XXIV of the GATT, Article V of GATS and the Enabling Clause.<sup>139</sup> Article XXIV<sup>140</sup> of the GATT provides for the formation and operation of Customs Unions

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<sup>135</sup> Fourth Edition (July, 2003) Available at:

<http://ctrc.sice.oas.org/trc/WTO/Documents/Dictionary%20of%20trade%20policy%20terms.pdf> accessed on 19<sup>th</sup> February, 2016

<sup>136</sup> Dictionary of Trade Policy Terms (n 135 above)

<sup>137</sup> Dictionary of Trade Policy Terms (n 135 above)

<sup>138</sup> P Kalenga *Cape to Cairo: Making the Tripartite FTA Work (2011)* 1 accessed from [www.tralac.org/2011/09/08/new-book-cape-to-cairo-making-the-tripartite-free-trade-area-work](http://www.tralac.org/2011/09/08/new-book-cape-to-cairo-making-the-tripartite-free-trade-area-work) on 18<sup>th</sup> November, 2015

<sup>139</sup> J Gathii *African Regional Trade Agreements as Legal regimes* (2011) 86

<sup>140</sup> Paragraphs 4 -10 of Article XXIV as clarified in the Understanding on the Interpretation of Article XXIV of the GATT (1994)

(CU), Free Trade Areas (FTAs) and Agreements leading to the formation of FTAs and CUs, covering trade in goods.<sup>141</sup>

A Free Trade Area (FTA) is formed when two or more customs territories enter into an agreement leading to elimination of duties and other restrictive trade regulations on products originating in their constituent territories.<sup>142</sup> Each of the territories, however, retains its own tariffs in respect of trade with other countries not party to the said Agreement and the right to conduct its own trade policy.<sup>143</sup> Further, FTA members are required to devise preferential rules of origin to allow for identification of goods originating from the constituent territories.<sup>144</sup>

A Customs Union, on the other hand, is formed by substituting a single customs territory for two or more customs territories, with the result that duties and other restrictive trade regulations are eliminated on products originating within the constituent territories.<sup>145</sup> Further, a customs union operates a common external tariff (CET)<sup>146</sup> on products from third party countries not members of the Union.<sup>147</sup> It is also usually the case that members of a fully formed and operational Customs Union conduct a common trade policy.<sup>148</sup> However, given that all constituent territories of a Customs Union are required to impose the same external tariff on goods from third party countries, it is not necessary to put in place preferential rules of origin.<sup>149</sup>

The Enabling Clause<sup>150</sup> also allows for the formation of preferential trade arrangements in trade in goods between developing countries. It provides for preferential tariff treatment to be given to product of developing countries by developed countries in accordance with the Generalized System of Preferences (GSP).<sup>151</sup> Unlike the requirement under GATT Article XXIV, developing countries have a right to make agreements for the mutual reduction of tariffs and

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<sup>141</sup> Paragraphs 4 -10 of Article XXIV as clarified in the Understanding on the Interpretation of Article XXIV of the GATT (1994)

<sup>142</sup> Article XXIV (8)(b)of GATT (1994)

<sup>143</sup> K Ahmed *An analysis of regional integration in Southern Africa: A South African perspective* (2011) 6

<sup>144</sup> K Ahmed (n 143 above)

<sup>145</sup> Article XXIV (8)(a)(i) of GATT, 1994

<sup>146</sup> The constituent territories are to apply substantially the same tariffs and other trade regulations to products of countries not members of the Union

<sup>147</sup> Article XXIV of GATT (1994) at paragraph 8(a)(ii)

<sup>148</sup> K Ahmed (n 143 above)

<sup>149</sup> K Ahmed (n 143 above)

<sup>150</sup> Also known as the “Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries”, was adopted under GATT in 1979 to enable developed members to grant differential and more favourable treatment to developing countries.

[https://www.wto.org/english/tratop\\_e/devel\\_e/dev\\_special\\_differential\\_provisions\\_e.htm](https://www.wto.org/english/tratop_e/devel_e/dev_special_differential_provisions_e.htm) accessed on 5 October, 2015

<sup>151</sup> [https://www.wto.org/english/tratop\\_e/devel\\_e/dev\\_special\\_differential\\_provisions\\_e.htm](https://www.wto.org/english/tratop_e/devel_e/dev_special_differential_provisions_e.htm) accessed on 5 October, 2015

non-tariff measures, without reference to eliminating duties on “substantially all trade” and without the requirement that there be a reciprocal exchange of duty eliminations between the members.<sup>152</sup> The rules under the Enabling Clause are thus more relaxed on the requirements for the formation of RTAs between developing countries.

On the other hand, GATS Article V allows for the formation of RTAs in respect of trade in services for both developed and developing countries. Since GATS is relatively new, not many agreements have been notified under it.<sup>153</sup>

### **3.4 RTAs as policy instruments for trade and investment**

As a policy instrument for trade and investment, RTAs promote the expansion of trade between their member states by giving them preferential access to specified products through the reduction or in some cases complete elimination of tariffs.<sup>154</sup> GATT principles of Most Favoured Nation principle (MFN) treatment require that any arrangement between two countries to give trade preferences or lower rates of tariffs between them must automatically be extended to all WTO members.<sup>155</sup> As an exception to this requirement, Article XXIV of GATT allows for a deviation in this principle through regional trade agreements provided that the provisions relating to such formation are adhered to.<sup>156</sup>

RTAs are of benefit to their member countries in that they facilitate removal or reduction of trade barriers between member states thereby lowering the cost of exporting for these countries.<sup>157</sup> Where Free Trade Agreement (FTA) or Customs Unions are concerned, RTAs essentially enlarge the size of the “domestic market” by allowing goods and services to freely move across the borders of their member states.<sup>158</sup> Further, RTAs provide firms manufacturing for exports with access to possibly higher quality and lower cost inputs than what would have been available in the domestic market.<sup>159</sup> This is due to allowed duty free import of inputs between member countries.

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<sup>152</sup>J Mathis & J Breaton *Regional Trade Agreements and the WTO: Implication for Eastern and Southern Africa* (2011) 3

<sup>153</sup>K Ahmed (n 143 above)

<sup>154</sup>T Farole *Special Economic Zones in Africa: Comparing Performance and learning from Global Experience* (2011) 129

<sup>155</sup>Farole (n 154 above) 129

<sup>156</sup>Farole (n 154 above) 129

<sup>157</sup>Farole (n 154 above) 129

<sup>158</sup>Farole (n 154 above) 130

<sup>159</sup>Farole (n 154 above) 130

In terms of wider economic gains, RTAs facilitate industrial restructuring translating to more specialized, competitive and higher scale producers.<sup>160</sup> This is because the stiff competition arising from reduced barriers to trade and investment across borders causes the less productive and competitive firms to exit the market either through mergers or acquisitions by larger or more productive firms, hence resulting in increased efficiency, greater production scale and lower costs of production.<sup>161</sup> The end result of such competition is reduced prices to consumers.

In terms of economic development, RTAs can facilitate specialization and industrialization in that in smaller markets such as most African economies, firms are generally under strict limits of degree of specialization that they can achieve given the requirements for them to cover their fixed costs.<sup>162</sup> By increasing the scale of the accessible market in the region, however, RTAs can enable specialization of such firms while maintaining sufficient economies of scale.<sup>163</sup>

One of the most critical implications of RTAs to firms is that RTAs change regional markets from export markets into “virtual” domestic markets.<sup>164</sup> For SEZ based firms, this can create significant opportunities given the kind of incentives that SEZ firms especially EPZs enjoy in terms of duty free imports and fiscal incentives as well as restricted sale to the market.<sup>165</sup> On the other hand, RTAs may be disadvantageous to SEZ firms as RTA formation may result into loss of their preferential position in selling to the regional market unlike non-SEZ based firms.<sup>166</sup>

### **3.5 Gains from regional integration**

Some of the gains that arise to countries who pursue regional integration include:

#### **3.5.1 Trade Gains**

RTAs enable consumers in member countries to easily access substitutes for goods from across the region thereby causing demand for these goods to decrease hence lowering their prices.<sup>167</sup> Further, more competition in the trade zone has a potential to induce external firms to reduce

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<sup>160</sup> Farole (n 154 above) 130

<sup>161</sup> Farole (n 154 above) 130

<sup>162</sup> Farole (n 154 above) 130

<sup>163</sup> Farole (n 154 above) 130

<sup>164</sup> Farole (n 154 above) 130

<sup>165</sup> Farole (n 154 above) 130

<sup>166</sup> Farole (n 154 above) 130

<sup>167</sup> L Kritzinger-van Niekerk *Regional Integration: Concepts, Advantages, Disadvantages and Lessons of Experience* (undated) 2

their prices in order to maintain exports to the region thus creating positive terms of trade effect for member countries.<sup>168</sup>

### **3.5.2 Investment**

RTAs may attract Foreign Direct Investment (FDI) both from within and outside the regional integration bloc as a result of enlarged market, especially large investment that might be more viable above a certain size as well as rationalization of production through reduced distortion and marginal cost in production.<sup>169</sup> An enlarged sub-regional market may also bring in direct investment from within the region.<sup>170</sup>

### **3.5.3 Increased returns and competition**

RTAs form enlarged markets which makes it possible for existence of larger firms with greater productive efficiency for industries with economies of scale.<sup>171</sup> Enlarged markets also result in increased competition that causes firms to reduce their prices, expand their sales and reduce their internal inefficiencies.<sup>172</sup> As such market enlargement arising from regional integration allows firms in fragmented markets to exploit economies of scale more fully.<sup>173</sup> Further, increased competition helps firms to rationalize their production and to remove inefficiencies and duplication of plants.<sup>174</sup>

## **3.6 Kenya in regional integration**

Kenya is a member of multiple regional integration arrangements ranging from the East African Community (EAC), the Common Market for East and Southern Africa (COMESA), Intergovernmental Authority on Development (IGAD) and the African Union (AU). It does not escape the mind that there are currently discussions to establish a Tri-partite Free Trade Area (T-FTA) between COMESA, EAC and Southern African Development Community (SADC) member states while the AU is also championing the establishment of a Continental Free Trade Area (C-FTA) to cover all African countries as an overarching continental development strategy.<sup>175</sup>

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<sup>168</sup> Kritzinger-van Niekerk (n 167 above) 2

<sup>169</sup> Kritzinger-van Niekerk (n 167 above) 2

<sup>170</sup> Kritzinger-van Niekerk (n 167 above) 2

<sup>171</sup> Kritzinger-van Niekerk (n 167 above) 2

<sup>172</sup> Kritzinger-van Niekerk (n 167 above) 2

<sup>173</sup> Kritzinger-van Niekerk (n 167 above) 2

<sup>174</sup> Kritzinger-van Niekerk (n 167 above) 2

<sup>175</sup> United Nations Economic Commission for Africa (UNECA) *Assessing Regional Integration in Africa: Towards an African Continental Free Trade Area* (2012) xv

### 3.6.1 The East African Community (EAC)

The Treaty establishing the East African Community was signed on 30<sup>th</sup> November 1999, and entered into force on 7<sup>th</sup> July, 2000. Its original members were Tanzania, Kenya and Uganda with Burundi and Rwanda later joining the community in the year 2007.

The overall goal of the East African Community is to “widen and deepen economic, political, social and cultural integration in order to improve the quality of life of the people” of the member states through value added production, trade and investment and improved competitiveness.<sup>176</sup>

The EAC Treaty aims to establish an export oriented economy that will enable the free movement of goods, services, labour, persons, information technology and capital in the region<sup>177</sup>. The Treaty establishing the EAC aims, through a series of transitional stages consisting of a Customs Union, a Common Market and a Monetary Union, to eventually establish a Political Federation.

#### *The East African Community Customs Union*

The Protocol establishing the EAC Customs Union was signed on 2<sup>nd</sup> March, 2004<sup>178</sup> and entered into force on 1<sup>st</sup> January, 2005. The Protocol sets out the requirement for the formation of the East African Community Customs Union (EACCU) within a period of five years after the Protocol enters into force.<sup>179</sup> Some of the objectives of the Customs Union include ‘further liberalizing intra-regional trade in goods through mutually beneficial trade arrangements among the state parties; promoting efficient production within the region; enhancing domestic , cross border and foreign investment in the region as well as promoting economic development and diversification of industries in the Community.’<sup>180</sup>

With the full implementation and operationalization of the customs union on 1 January 2010, a zero tariff is applied on trade in goods from partner states, with a few exceptions based on an agreed “list of sensitive goods”.<sup>181</sup> The Customs Union also allows for free movement of people across the member states. Intraregional trade has further been promoted by making the

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<sup>176</sup> EAC Development Strategy 2006-10, Executive Summary, 7, accessed from [www.eac.int/home.html](http://www.eac.int/home.html). On 3 October, 2015

<sup>177</sup> The East African Community Treaty, Article 7 © accessed from [www.eac.int](http://www.eac.int) on 2 October, 2015

<sup>178</sup> This treaty effectively re-established the EAC, which was originally set up in 1967 but disbanded in 1977

<sup>179</sup> Part B Article 11 (1),The EAC Customs Union Protocol, available at [www.eac.int/customs](http://www.eac.int/customs) accessed on 2nd February, 2016.

<sup>180</sup> Part B Article 3,The EAC Customs Union Protocol, available at [www.eac.int/customs](http://www.eac.int/customs) accessed on 2nd February, 2016.

<sup>181</sup> UNECA (n 175 above) 17

currencies of Kenya, Tanzania and Uganda freely convertible.<sup>182</sup> It therefore means that the EAC Partner States have reached an agreement on establishing free trade on goods and services amongst themselves and to have a common external tariff (CET) for externally originating products, whereby goods from non-EAC member states are subjected to similar tariff when entering any EAC Partner State.

### ***EAC Rules of Origin***

Goods moving freely within the EAC must adhere to the EAC Rules of Origin and with provisions under the Protocol for the Establishment of the East African Community Customs Union.<sup>183</sup> Rules of origin are a set of rules or the criteria needed to determine the national source of a product.<sup>184</sup> They are important in determining duties applicable on imports since such duties and restrictions in several cases depend upon the source of imports.<sup>185</sup> Rules of origin are used to determine whether imported products are to receive preferential treatment or most favoured nation (MFN) treatment. Only products originating in a country with which the importing country has a preferential trade arrangement are conferred preferential treatment by charging on them an agreed preferential tariff/import duty. On the other hand, products from states with which the importing state has no preferential trade arrangement are charged an MFN tariff which is the tariff that the importing country notifies the WTO as its applied tariff and applies to all other countries without discrimination.

### ***Kenya's Role in EAC***

Kenya is an important member of the East African Community and a key player in most sectors of the regional economy. As a regional financial and export hub, Kenya has been fundamental to the process of regional integration in the Community.<sup>186</sup> Kenya remains to be the most industrially advanced among the five member states and the region's industrial and manufacturing hub hence an important member in the integration initiative.<sup>187</sup>

Kenya has also been cited as the country whose central leadership and coordination is required for integration within the EAC to gain the much-needed momentum.<sup>188</sup> Recommendations

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<sup>182</sup> Economic Commission for Africa (ECA) *Annual Report on Regional Integration in Africa* (2008) 214

<sup>183</sup> <http://www.eac.int/integration-pillars/customs-union> - accessed on March 24, 2016

<sup>184</sup> [https://www.wto.org/english/tratop\\_e/roi\\_e/roi\\_info\\_e.htm](https://www.wto.org/english/tratop_e/roi_e/roi_info_e.htm) - accessed on March 21, 2016

<sup>185</sup> [https://www.wto.org/english/tratop\\_e/roi\\_e/roi\\_info\\_e.htm](https://www.wto.org/english/tratop_e/roi_e/roi_info_e.htm) - accessed on March 21, 2016

<sup>186</sup> Economic Commission for Africa (ECA) *Annual Report on Regional Integration in Africa* (2008)

<sup>187</sup> Stratfor Global Intelligence December 5, 2013 | 11:33 GMT Kenya's Dominance in the East African Community <https://www.stratfor.com/analysis/kenyas-dominance-east-african-community>

<sup>188</sup> M Mugisha *Kenya Should take Central Role in EAC integration* (4<sup>th</sup> February, 2015) the Observer <http://www.observer.ug/viewpoint/guest-writers/36238-kenya-should-take-central-role-in-eac-integration>

have also been made citing Kenya as the country with the capacity and ability to scale up efforts towards addressing the key structural constraints within the community such as infrastructure and technological capabilities development to address the challenges that inhibit industrialization and growth within the region.<sup>189</sup>

This is because Kenya's economy is by any considered measure more developed than any other economy within the East African Community region<sup>190</sup>. It has a more diversified manufacturing sector, more developed financial and investment sector, better technological capabilities, a moderately-skilled and professional workforce and more importantly, access to the sea.<sup>191</sup>

Further, compared to its regional neighbours, Kenya has by far the most developed financial and banking system with Kenya Commercial Bank being one of Africa's leading investment institutions and a significant financier to Tanzania and Rwanda.<sup>192</sup> Kenya's banks are also expanding their physical presence in neighbouring countries, and international banks use Nairobi as a base from which they provide services to the East African region.<sup>193</sup> The Nairobi Securities Exchange is also the largest exchange in the region, ensuring that as the rest of the East African Community members develop their financial systems.<sup>194</sup> These factors therefore put Kenya at the forefront and indicate that it will continue to hold a key position among the EAC member states.<sup>195</sup>

In terms of trade, Kenya continues to be the dominant regional exporter within the community because being the most industrially advanced gives it the capacity to lead in the export of manufactured products to the neighbouring countries.<sup>196</sup> Further, the country has an expansive transportation network that provides vital supply chains into the Great Lakes region of Africa thus enhancing its ability to export to its neighbouring states.<sup>197</sup> Uganda is Kenya's largest export partner, receiving more goods and commodities from Kenya than to the rest of the community combined.<sup>198</sup>

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<sup>189</sup> M Mugisha Kenya Should take Central Role in EAC integration (4<sup>th</sup> February, 2015) the Observer <http://www.observer.ug/viewpoint/guest-writers/36238-kenya-should-take-central-role-in-eac-integration>

<sup>190</sup> Mugisha (n 188 above)

<sup>191</sup> Stratfor Global Intelligence (n 187 above)

<sup>192</sup> Mugisha (n 188 above)

<sup>193</sup> Mugisha (n 188 above)

<sup>194</sup> Mugisha (n 188 above)

<sup>195</sup> Stratfor Global Intelligence (n 187 above)

<sup>196</sup> Mugisha (n 188 above)

<sup>197</sup> Mugisha (n 188 above)

<sup>198</sup> Mugisha (n 188 above)

### 3.6.2 COMESA

The Common Market for Eastern and Southern Africa (COMESA) is one of the largest trading blocs in Africa. COMESA was established in December 1994 to replace the then Preferential Trade Area (PTA) which had been in existence since the earlier days of 1981.<sup>199</sup> COMESA, in its Treaty, was established as an organisation of free independent sovereign states which have agreed to co-operate in developing their natural and human resources for the good of all their people.<sup>200</sup> This gave it a wide-ranging series of objectives including the promotion of peace and security in the eastern and southern African region.<sup>201</sup> COMESA's main focus however has been the formation of a large economic and trading unit capable of overcoming trade barriers among the individual states summing up its strategy in the phrase 'economic prosperity through regional integration.'<sup>202</sup>

COMESA is made up of 19 member state comprising Burundi, Union of the Comoros, Democratic Republic of the Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Libya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Kingdom of Swaziland, Uganda, Zambia and Zimbabwe.<sup>203</sup>

#### *COMESA Free Trade Area (FTA)*

COMESA achieved its FTA status on 31st October, 2000 when, following a trade liberalisation programme that began in 1984 on reduction and eventual elimination of tariff and non-tariff barriers to intra-regional trade, nine of its member States namely Djibouti, Kenya, Madagascar, Malawi, Mauritius, Sudan, Zambia and Zimbabwe eliminated their tariffs on COMESA originating products, in keeping with the tariff reduction schedule adopted in 1992.<sup>204</sup> These

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<sup>199</sup> [http://about.comesa.int/index.php?option=com\\_content&view=article&id=95&Itemid=117](http://about.comesa.int/index.php?option=com_content&view=article&id=95&Itemid=117) accessed: 20 March, 2016

<sup>200</sup> [http://about.comesa.int/index.php?option=com\\_content&view=article&id=95&Itemid=117](http://about.comesa.int/index.php?option=com_content&view=article&id=95&Itemid=117) accessed 20 March, 2016

<sup>201</sup> [http://about.comesa.int/index.php?option=com\\_content&view=article&id=95&Itemid=117](http://about.comesa.int/index.php?option=com_content&view=article&id=95&Itemid=117) accessed 20 March, 2016

<sup>202</sup> [http://about.comesa.int/index.php?option=com\\_content&view=article&id=95&Itemid=117](http://about.comesa.int/index.php?option=com_content&view=article&id=95&Itemid=117) accessed 20 March, 2016

<sup>203</sup> [http://about.comesa.int/index.php?option=com\\_content&view=article&id=123&Itemid=121](http://about.comesa.int/index.php?option=com_content&view=article&id=123&Itemid=121) accessed 20 March, 2016

<sup>204</sup> [http://about.comesa.int/index.php?option=com\\_content&view=article&id=123&Itemid=121](http://about.comesa.int/index.php?option=com_content&view=article&id=123&Itemid=121) accessed 20 March, 2016

eleven FTA members have in addition to eliminating customs tariffs on their products, are working on the ultimate elimination of quantitative restrictions and other non-tariff barriers.<sup>205</sup>

### ***COMESA Customs Union***

COMESA Free Trade Area (FTA) was officially created in the year 2000. However, only nine of its members were willing and able to participate in the integration.<sup>206</sup> While the establishment of a Customs Union was originally planned for 2004 the plan was later postponed to 2008. The envisioned Customs Union has however not materialised to date and it is still not clear when the customs union will be implemented.<sup>207</sup>

### **3.7 Rationale for regional integration**

Many literatures talk of regional integration as a concept suitable for developed economies but are silent on their suitability on developing states.<sup>208</sup> Be that as it may, developing economies (African countries included) have historically and in the recent past pursued regional integration as part of their economic development agenda.<sup>209</sup> There has in the recent years been a proliferation of regional trade arrangements in Africa with many states being members in more than one such arrangement.<sup>210</sup> In the African context, regional integration has been seen as a critical strategy to address challenges posed by small domestic markets, limited economies of scale and marginalization of African economies in world trade.<sup>211</sup>

At the outset it is good to note that since the formation of these RTAs finds their basis on the provisions of the WTO Trade Agreements, they must be evaluated for their consistency or otherwise with the WTO Rules and objectives. To enable such evaluation, one would need to know what the objectives of the WTO are so as to evaluate them against the objectives of the subject RTA. With the main objective of the WTO being the liberalization of trade among partner states through elimination of barriers to trade which include tariff and non-tariff trade barriers and restrictive regulations of commerce, an RTA can only be said to be WTO compliant if it furthers the overall objective of trade liberalization.

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<sup>205</sup> [http://about.comesa.int/index.php?option=com\\_content&view=article&id=123&Itemid=121](http://about.comesa.int/index.php?option=com_content&view=article&id=123&Itemid=121) accessed 20 March, 2016

<sup>206</sup> C Peters – Berries *Regional Integration in Southern Africa: A Guide Book* (2010) 63

<sup>207</sup> Peters – Berries (n 206 above) 63

<sup>208</sup> Peters – Berries (n 206 above) 13

<sup>209</sup> Peters – Berries (n 206 above) 13

<sup>210</sup> T Farole *Special economic Zones: Progress, Emerging Challenges and Future Desires* (2011) 132

<sup>211</sup> Peters – Berries (n 206 above) 13

It is however worth noting that most African RTAs are not exclusively or purely trade agreements but rather encompass a broad set of objectives.<sup>212</sup> A good example of this analogy is the Treaty Establishing the African Economic Community which has one of its purposes as the facilitation of cooperation “in every field of human endeavour”<sup>213</sup>. Such an objective is clearly quite broad and general and therefore contrasts sharply with the GATT/WTO regime that is largely premised on trade liberalization and more specifically the principle of non-discrimination.

Two main arguments have however been given as being the rationale for regional integration. These arguments give either economic or political reasons for regional integration:

### **3.7.1 Economic arguments**

Economic arguments for regional integration suggest that creation of bigger markets; improvement of citizens’ welfare; attractiveness for development funding and globalisation requirements are the reasons behind regionalism.<sup>214</sup>

#### ***Creation of bigger markets***

Regional Integration has been classified as one of the most promising approaches to overcoming economic balkanization of many parts of the African continent.<sup>215</sup> This is because most parts of the African continent consists of a patchwork of small and often economically unviable states with 38 out of 53 African states having populations of less than 15 million people and a third of African countries with less than 3 million people.<sup>216</sup> For such small states, the choice is between uniting by integrating regionally to create a larger market or continue in the misery posed by small markets and hence poverty.<sup>217</sup>

The argument is that such small states are unable to overcome the limitations of their markets by themselves hence forming integrated regional bodies that consist of economies of several of such small states would provide a larger population and demand base thereby creating economies of scale which industries can take advantage of when providing goods and services.<sup>218</sup>

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<sup>212</sup>J Gathii (n 139 above) xxviii

<sup>213</sup> J Gathii (n 139 above) xxviii

<sup>214</sup> Peters – Berries (n 206 above) 14

<sup>215</sup> United Nations Economic Commission for Africa (UNECA) *Assessing Regional Integration in Africa: Towards an African Continental Free Trade Area* (2008 ) 23

<sup>216</sup> United Nations Economic Commission for Africa (UNECA) (n 215 above) 23

<sup>217</sup> Peters – Berries (n 206 above) 14

<sup>218</sup> Peters – Berries (n 206 above) 14

Further, bigger markets allow for the effective allocation of factors of production i.e. capital and labour thereby allowing for concentration of investment in countries with the most suitable conditions for instance good infrastructure or cheaper labour.<sup>219</sup> Such concentration of investments in countries with the best conditions leads to more efficient, less expensive and more competitive production. Such increase in competitiveness and efficiency, it is argued, leads to an increase in the rate of foreign direct investment as well as investment from internal sources.<sup>220</sup>

### ***Improvement of citizens' welfare***

It is argued that regional integration can help improve social and economic welfare of the citizens of the member states of the regional integration arrangement. The argument is that if a regional trade agreement such as a customs union imposes high external tariffs but eliminates all internal duties within the regional trade arrangement, the members of the regional bloc will realise better national economic and social welfare.<sup>221</sup> This is as a result of trade creation within the integration region leading to increased rates of investment.<sup>222</sup> Increased trade and investment lead to creation of more jobs, higher incomes, increased demand for goods and services translating to economic growth and better living conditions for the people.

### ***Attractiveness for development funding***

While creation of bigger markets and improved citizens' welfare are 'traditional' arguments for regional integration, attractiveness for development funding is a modern argument in support of regional integration.<sup>223</sup> The argument is that regional integration can help in attracting more funding for project development especially for developing countries or regions.<sup>224</sup> From this point of view, Regional integration is seen to be particularly attractive to donors who fund big-development projects for instance multilateral donor agencies such as the EU, specialized private donors and development banks.<sup>225</sup>

This attractiveness to development funding is because regional integration allows the realisation of development projects that are not economically viable at the national level but make more economic sense at the regional level.<sup>226</sup> Such projects include:

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<sup>219</sup> Peters – Berries (n 206 above) 14

<sup>220</sup> Peters – Berries (n 206 above) 14

<sup>221</sup> Peters – Berries (n 206 above) 15

<sup>222</sup> Kritzinger-van Niekerk (n 167 above) 2

<sup>223</sup> Peters – Berries (n 206 above) 16

<sup>224</sup> Peters – Berries (n 206 above) 16

<sup>225</sup> Peters – Berries (n 206 above) 16

<sup>226</sup> Peters – Berries (n 206 above) 16

- Cross-border projects such as roads, railway lines, electrical grids, dams and environmental conservation areas, which cannot be realised at national levels but make economic and environmental sense.<sup>227</sup>
- Capacity building projects of a regional nature, for instance training funds and/or research stations and specialised universities, which are yet to be established nationally due to lack of capacity or demand.<sup>228</sup>
- Regional policy support for crime prevention efforts e.g. drug trafficking, human trafficking, etc.; health sector initiatives such as HIV/Aids, polio, malaria, etc.; investment promotions (e.g. in tourism) all of which often make more sense in a regional rather than a national context.<sup>229</sup>
- Creation of institutions or bodies such as police services, meteorological services and electrical power pools which at the regional level as such services require regional orientation to be effective. Such institutions are important infrastructure tools required for sustainable socio-economic development and attainment of the Millennium Development Goals for African countries.<sup>230</sup>

### ***Globalisation requirements***

Another contemporary argument in support of regional integration relates to globalisation.<sup>231</sup> It is argued that regional integration is seen as particularly necessary for African countries to help integrate them into the global economy.<sup>232</sup> For Africa, Globalisation refers not only to more liberalised and intensive trade and investment regimes, a rise in the number of mobile experts and an opportunity to realize fast economic growth and wealth, and intensified currency and stock market speculation but also refers to a status of being permanently excluded from the chance of ever reaching a sustainable socio-economic development level.<sup>233</sup>

Africa has for a long time now been typically a mere supplier of raw materials, tourist attraction and genetic variance and the threat that this position if not addressed through change of policy might be the case in many years to come is imminent.<sup>234</sup> Development experts argue that such change of policy can only be achieved if African countries are to formulate, publicise and

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<sup>227</sup> Peters – Berries (n 206 above) 16

<sup>228</sup> Peters – Berries (n 206 above) 16

<sup>229</sup> Peters – Berries (n 206 above) 16

<sup>230</sup> Peters – Berries (n 206 above) 16

<sup>231</sup> Peters – Berries (n 206 above) 16

<sup>232</sup> Peters – Berries (n 206 above) 16

<sup>233</sup> Peters – Berries (n 206 above) 17

<sup>234</sup> Peters – Berries (n 206 above) 17

defend their often similar interests concerning global issues and not sit on the fence like mere spectators while major global players like the EU are negotiating over the rules and structures to shape the future world at international organisations.<sup>235</sup> In order to have better chance at negotiating at the global level and be able to influence decisions more easily, African countries need to speak as regional blocs (at least until the AU becomes more efficient) and not as individual countries as that would give them more bargaining power.<sup>236</sup> This is because regional blocs would have more weight in international organizations such as the WTO and would be able to make their positions and interests be better heard and count.<sup>237</sup>

It is also argued that regional integration would help African countries have a stronger position in investment negotiations such as negotiations of Economic Partnership Agreements (EPAs) with the EU.<sup>238</sup> Finally, regional integration would offer African countries better positions in enforcing their environmental, social, legal and economic standards when negotiating with multinational corporations as compared to when small countries singlehandedly deal with such powerful global players.<sup>239</sup>

### **3.7.2 The political rationale for regional integration<sup>240</sup>**

Political arguments for regional integration lay emphasis on matters to do with security, increased international negotiation power, democracy and the desire to create ‘natural’ sociocultural and political entities.

#### ***Security***

Political scientists contend that regional integration can improve the national and regional security situation in regions that are politically unstable and volatile as is the case with most African countries.<sup>241</sup>

The argument is that the probability of armed conflict is high in regions where states are not fully consolidated and integrated or where there exists failed states.<sup>242</sup> Regional integration schemes that also incorporate such failed states can therefore greatly reduce the potential for conflict.<sup>243</sup> Further, regional integration can help protect a region from external attacks hence

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<sup>235</sup> Peters – Berries (n 206 above) 17

<sup>236</sup> Kritzinger-van Niekerk (n 167 above) 3

<sup>237</sup> Peters – Berries (n 206 above) 17

<sup>238</sup> Kritzinger-van Niekerk (n 167 above) 3

<sup>239</sup> Kritzinger-van Niekerk (n 167 above) 3

<sup>240</sup> Peters – Berries (n 206 above) 17

<sup>241</sup> Kritzinger-van Niekerk (n 167 above) 3

<sup>242</sup> Kritzinger-van Niekerk (n 167 above) 3

<sup>243</sup> Kritzinger-van Niekerk (n 167 above) 3

offering further protection given that an external aggressor may be afraid to engage an entire region in a conflict.<sup>244</sup>

Secondly, if a regional body establishes principles against recognising governments created through armed conflict, such principles can be safeguards against coup de tats or armed rebellion in the region.<sup>245</sup> A regional body could also provide safe guard against such armed conflict by providing military intervention in member countries facing armed conflicts.<sup>246</sup> Further, through joint intelligence and policing strategies, regional bodies can help improve security in the region by coming together in the fighting terrorism and other international crimes such as money laundering.<sup>247</sup>

### ***Democratic convergence***

Regional integration has the potential to increase a region's democratic convergence as was the case for Bulgaria and Romania when they joined the EU.<sup>248</sup> A prosperous and economically lucrative regional body can facilitate countries which are in urgent need of becoming its members to adopt democratic principles and standards.<sup>249</sup> This is possible even for countries with undemocratic traditions if the regional bloc demands such adoption as a precondition for gaining its membership.<sup>250</sup>

Similarly, where a regional integration body consists of countries with different democratic backgrounds, the setting of democratic convergence standards could help to influence even unwilling and undemocratic members to implement democratic reforms in order for them to remain member states.<sup>251</sup>

### ***Putting-together-what-belongs-together***<sup>252</sup>

This argument is particularly persuasive in the African context where in most cases it is perceived that boundaries were arbitrarily drawn by previous colonial powers and current states are not a true reflection of how people settled historically or the economic exchange patterns.<sup>253</sup>

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<sup>244</sup> Peters – Berries (n 206 above) 17

<sup>245</sup> Peters – Berries (n 206 above) 18

<sup>246</sup> Peters – Berries (n 206 above) 18

<sup>247</sup> Peters – Berries (n 206 above) 18

<sup>248</sup> Peters – Berries (n 206 above) 18

<sup>249</sup> Peters – Berries (n 206 above) 19

<sup>250</sup> Peters – Berries (n 206 above) 19

<sup>251</sup> Peters – Berries (n 206 above) 19

<sup>252</sup> Peters – Berries (n 206 above) 19

<sup>253</sup> Peters – Berries (n 206 above) 19

Thus regional integration comes in as an instrument to put together states that feel they belong together.<sup>254</sup>

### **3.8 Conclusion**

In conclusion, regional integration initiatives have been pursued by countries as an instrument for trade and investment and as a means to avoid challenges associated with small markets. Some of the advantages of regional integration include increased bargaining power for the region, attraction of foreign investment, generation of trade gains arising from increased economies of scale, reduced cost of production and increased competition which leads to more efficiency and lower prices as well as improved welfare for the citizens.

Kenya as a country has actively pursued and participated in multiple regional trade arrangements ranging from the EAC, COMESA and IGAD. The country is a key member of the East African Community being the most industrially developed and with the most diversified manufacturing sector.<sup>255</sup> Through its membership in the East African Community and other regional bodies, the country seeks to achieve several gains associated with regional integration particularly benefits of free trade, an enlarged market for its manufactured products as well as free imports of inputs for production by its manufacturers.

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<sup>254</sup> Peters – Berries (n 206 above) 19

<sup>255</sup> Stratfor Global Intelligence (n 187 above)

## CHAPTER 4

### 4 RTAs AND SEZs: WHERE IS THE CONFLICT?

#### 4.1 Introduction

Having looked separately at the concepts of SEZs and RTAs respectively in the previous two chapters in order to see the rationale behind their implementation by countries, the writer will now bring the two concepts together in this chapter to determine how the two relate to each other and find out if there is any potential for conflict in a situation where the two are used simultaneously. It is also clear from the previous two chapters that Kenya is pursuing regional integration and is a key member in the East African Community and at the same time, the country has just passed a Special Economic Zones Act seeking to establish Special Economic Zones in the country. It is therefore worthwhile to examine the interplay between these two instruments both of which are said to promote industrialization and economic development in the country.<sup>256</sup>

SEZs and RTAs, as have been widely discussed in the two previous chapters, are used as trade and investment tools by countries and this chapter therefore seeks to explore the relationship between them and in case any conflict, economic or legal, exists in their simultaneous use if there is potential for synergy and how this can be achieved.

Although the challenges and conflict arising from the simultaneous use of SEZs and RTAs in a country are mostly economic challenges best analysed in economic terms as will be discussed in this Chapter, such challenges arise as a result of legal and regulatory frameworks in place. Such challenges are also best addressed through legal and regulatory instruments through the use of proper legal provisions both at the national as well as the regional level.

#### 4.2 The relationship between RTAs and SEZs

Economists argue that the existence of RTAs affects the possibility of creation of SEZs in member states of RTAs and alters extensively the business environment for the operations of SEZ enterprises thus making the relationship between the two mechanisms quite complex.<sup>257</sup> This argument is premised on the fact that the two phenomena are driven by somewhat conflicting economic rationales given that while RTAs are bilateral or multilateral

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<sup>256</sup> S Woolfrey, Chapter 7, *Special Economic Zones and Regional Integration in Africa* (2013) 122 chapter in book *Cape to Cairo: Exploring the Tripartite FTA Agenda* <http://www.tralac.org/images/docs5548/cape-to-cairo-4complete.pdf> - accessed on October 10, 2015

<sup>257</sup> Woolfrey (n 255 above)

arrangements, SEZs on the other hand are initiatives by individual countries to promote investments and exports potentially in competition with its RTA partner states.<sup>258</sup> Further, the primary logic of an RTA is that barriers to the movement of goods within a region are eliminated which is quite in contrast with the economic logic behind special economic zones which in most cases are dedicated to export oriented firms.<sup>259</sup>

Farole<sup>260</sup> for instance argues that the use of SEZ incentives to attract foreign direct investment as in the case of incentives offered in the Kenyan SEZ programme can result in a “race to the bottom” between neighbouring countries thereby potentially jeopardizing regional integration initiatives and processes.<sup>261</sup> Seen in this light, then in a developing country such as Kenya and the rest of the EAC member states where attracting FDI is one of the main rationales behind zone development and where such incentives are considered a development imperative, the “race to the bottom” risk is much higher.<sup>262</sup>

Ideally, such incentives are difficult to eliminate but rather prone to increment as public authorities are under pressure to increase and extend them in order to keep attracting FDI.<sup>263</sup> Farole likens the investment incentives race between neighbouring countries to a prisoner’s dilemma whereby, the neighbouring countries would do well for themselves if they are to cooperate in eliminating or regulating fiscal incentives to foreign investors but they each choose to act individually in the hope that each would benefit most by offering incentives while their neighbours do not.<sup>264</sup> Since it is difficult to determine which action other countries will take, it is likely that the countries will each act in their self-interest in offering incentives in the hope of beating their neighbours at it.<sup>265</sup> Farole however argues that if all countries in a region give investment incentives, they end up negating the effectiveness of the incentives and end up merely transferring rent to foreign investors.<sup>266</sup>

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<sup>258</sup> N Koyama, Chapter 6, *SEZs in the Context of Regional Integration: Creating Synergies for Trade and Investment*, (2011) 128. Chapter in book *Special economic zones: Progress, Emerging Challenges and Future Directions*

<sup>259</sup> J Granados *Export Processing Zones and Other Special Regimes in the Context of Multilateral and Regional Trade Negotiations* (2003) 2 available in pdf Format at [www.iadb.org/intal](http://www.iadb.org/intal) or [www.iadb.org/int](http://www.iadb.org/int)

<sup>260</sup> T Farole *Special Economic Zones in Africa: Comparing Performance and learning from Global Experience* (2011) 174

<sup>261</sup> Farole (n 259above) 174

<sup>262</sup> S Woolfrey *Special Economic Zones and Regional Integration in Africa* (2013) 15

<sup>263</sup> Farole (n 259above) 261

<sup>264</sup> Farole (n 259above) 179

<sup>265</sup> Woolfrey (n 261 above)

<sup>266</sup> S Woolfrey (n 261 above)

The SEZs programmes in Kenya and the larger East African region are characterized by significant fiscal and other incentives and therefore the potential for such collective action problems is more likely to happen. The other countries in the region also running SEZ programmes are Tanzania, Rwanda and Burundi. Tanzania for instance, enacted an EPZ Act in the 2002 but the programme has thus far not been able to successfully attract investment largely because of bureaucracy, poor infrastructure and corruption.<sup>267</sup> Uganda on the other hand is in the process of developing several business and industrial parks while Rwanda is also in the process of establishing special economic zones.<sup>268</sup> Burundi also has a free zone regime which according to the United Nations Conference on Trade and Development (UNCTAD), is not used in practice.<sup>269</sup>

Given that the governments in the region are under pressure to attract investment, create employment for their citizens and promote economic growth, they are unlikely to act unilaterally in abandoning their SEZ incentives.<sup>270</sup> Further, in a region where some countries are giving lucrative incentives to investors as part of their SEZ packages, a country in the same region would definitely find it illogical to establish its SEZ programme without resorting to similar incentives as those offered by its neighbours.<sup>271</sup>

According to Farole though, international investors only consider investment incentives after they have settled on the region where they want to invest in.<sup>272</sup> Accordingly, incentives alone do not influence investors' decision to invest in a region as several other factors play an important role in this decision. As such, incentive-based wars among countries at the regional level are not likely to translate into higher levels of investment in a region but are a waste of resources that could otherwise be used to promote regional growth.<sup>273</sup> Such wars can also aggravate economic tensions between regional neighbours hence threatening regional integration processes that may be in place.<sup>274</sup> Thus looked at from this perspective, SEZ programmes in regions which still put a lot of emphasis on national investment incentives have

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<sup>267</sup> B Hitimana 'Bridging trade deficit' *The Independent* 16 April 2012 available at <http://www.independent.co.ug/news/regional-news/5597-bridging-trade-deficit> (accessed 28 November, 2015)

<sup>268</sup> Hitimana (n 266 above)

<sup>269</sup> UNCTAD *Investment Policy Review Burundi: Main conclusions and recommendations* (2010) 4

<sup>270</sup> Woolfrey (n 261 above) 15

<sup>271</sup> Woolfrey (n 261 above) 15

<sup>272</sup> Farole (n 259 above) 182

<sup>273</sup> Farole (n 259 above) 182

<sup>274</sup> Woolfrey (n 261 above) 15

a potential of undermining regional integration processes that are also to a large extent motivated by a desire to boost foreign investment in the region.<sup>275</sup>

It is also important to point out the fact that regional integration processes in regions where SEZs have been established must consider issues to do with customs duty exemptions, deferrals or draw backs on the incentive packages that give preferential treatment to inputs; whether or not goods manufactured in the SEZ can be sold in domestic and regional markets as well as preferential rules of origin in relation to goods produced in the SEZ.<sup>276</sup> In particular, when SEZs grant tariff-related incentives to their investors like those offered in the Kenyan scenario, various issues arise in the context of regional integration.<sup>277</sup> For instance, tariff-related incentives may pose a challenge of tariff jumping.<sup>278</sup> Tariff jumping is the tendency for a foreign firm to jump over the tariff wall of a country in order to avoid tariff costs.<sup>279</sup> This may happen where a foreign firm uses an SEZ as a bulwark to enter the regional customs territory free of tariffs.<sup>280</sup> This is particularly possible in a case such as the Kenyan scenario and indeed many SEZs worldwide which allow duty free imports of inputs from outside territories, giving extra-RTA goods a leeway to enter the RTA duty-free through an SEZ and then leak into other RTA member states' customs territory.<sup>281</sup>

### **4.3 The EAC: Implications for SEZs in Kenya**

Kenya being a member of the East African Community has to comply with rules and regulations pertaining to the Community. In passing its national laws, the country has to ensure that the said laws are in compliance with the regional laws of the community. As such, the Special Economic Zones Act, 2015 has to be scrutinized for its compliance or conformity with the laws of the EAC.

#### **4.3.1 Regional Market Access**

The EAC being a Customs Union means that the entire region forms one single customs territory with the result that all customs duties and other restrictive trade regulations are eliminated as between the constituent states.<sup>282</sup> This means that ordinarily, goods coming out of Kenya into any other EAC member state should attract zero duty. The situation is different

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<sup>275</sup> Woolfrey (n 261 above) 15

<sup>276</sup> Woolfrey (n 261 above) 16

<sup>277</sup> Koyama (n 257 above) 128

<sup>278</sup> Koyama (n 257 above) 128

<sup>279</sup> Koyama (n 257 above) 128

<sup>280</sup> Koyama (n 257 above) 128

<sup>281</sup> Koyama (n 257 above) 129

<sup>282</sup> GATT (1994) Article XXIV (8)(a)(i)

though for goods originating from Special Economic Zones as SEZs are generally treated as being separate customs territories from those countries in which they are set up.<sup>283</sup> As such, SEZs being set up in Kenya are to be treated as being outside the country and hence outside the EAC customs union at least as far as customs duties are concerned. Article 4 of the SEZ Act, 2015 for instance provides that goods introduced and services provided in an SEZ are regarded, in so far as import duties and taxes are concerned, as being outside the customs territory of Kenya. This position therefore affects how goods and services from these SEZs are to be treated within the national and the regional market.

It is noteworthy that Kenya's Special Economic Zones Act, 2015 is silent on whether goods from the SEZs can be sold in the regional market. Indeed, the Act gives the Cabinet Secretary in charge of Trade and Industrialization the mandate to make regulations in respect of any matter that may be required under the Act.<sup>284</sup> No regulations have been made yet under the Act and one would be right to think that one of the matters which will require such regulation would be market access of SEZ-processed goods in the regional market. The Act however provides that goods and services originating from the SEZs into the Kenyan market are deemed to be imported into Kenya and as such are subject to applicable import duties.<sup>285</sup>

Even though there is that gap in law under the SEZ Act, there are regulations within the EAC framework which make provision for regional market access for products coming from SEZs in any of the Partner states. The East African Community Customs Union Protocol together with regulations under it - The EAC Customs Union Regulations, Annex VII on Export Processing Zones and The East African Community Customs Union (Freeport Operations) Regulations, Annex VIII provide for treatment of goods originating in SEZs and EPZs within the EAC region. These legislations exclude goods originating in SEZs from benefiting from the status of originating products.<sup>286</sup> Article 25 of the EAC Customs Union Protocol for instance provides that goods benefiting from export promotion schemes shall primarily be for export and in the event that they are sold within the customs territory then they shall attract full duties and other charges in the common external tariff.<sup>287</sup> Further, sale of such goods in the

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<sup>283</sup> Annex D to the International Convention on the Harmonization and Simplification of Customs (revised in 1999)

<sup>284</sup> Special Economic Zones Act, Section 39 (1)

<sup>285</sup> Special economic Zones Act, Section 6(b)

<sup>286</sup> Koyama (n 257 above) 142

<sup>287</sup> EAC Customs Union Protocol, Article 25 (2) (a) and (b)

customs territory is subject to authorization by a competent authority and is limited to only 20% of the company's annual production.<sup>288</sup>

It is therefore clear that one of the implications of regional integration through the EAC for SEZs in Kenya is the reduction in their market access to the regional market as a potential export market. This is because with the EAC operating as a single customs territory and limiting the amount of SEZ-processed goods allowed in this customs territory, this essentially turns what would have been regional export market for SEZ firms into domestic markets thereby reducing some of the advantages of being based in the SEZ.<sup>289</sup> Indeed, some SEZ investors are already asking Kenyan authority to change the rule that requires all SEZ firms to export at least 80 per cent of their products outside the East African regional market and allow them to sell more of their products to the regional EAC market.<sup>290</sup>

On the other hand, EPZ investors have also been pushing for the enlargement of the domestic market to include the East African Community because they are at the moment restricted to selling only 20 per cent of their annual produce to the Kenyan market while 80 per cent is exported outside the East African regional market.<sup>291</sup> It should also be pointed out that most SEZ investors are attracted to the EAC region because of the integration and the potential enlarged regional market resulting from such integration.<sup>292</sup> It is therefore almost irrational to have these investors come in and deny them market access to the regional market. If for instance SEZ firms were allowed to sell their produce into the regional market, they could provide excellent platforms for boosting interregional trade among RTA member countries and “promoting regional value chains and closer economic ties between the member states of the” RTA.<sup>293</sup>

But one may ask why regulating market access of SEZ- produced goods to the regional market is necessary. Some economic reasons underpin the necessity for regulating market access for SEZ produced goods within a regional context. The following are reasons why such regulation is necessary where RTAs and SEZs coexist as in the EAC case:

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<sup>288</sup> EAC Customs Union Protocol, Article 25 (3)

<sup>289</sup> Koyama (n 257 above) 142

<sup>290</sup> Trade Mark East Africa ‘Kenya now introduces special economic zones’ 28 September 2015 <https://www.trademarkea.com/news/kenya-now-introduces-special-economic-zones/> (accessed 21 May 2016)

<sup>291</sup> Trade Mark East Africa ( n 288 above)

<sup>292</sup> Trade Mark East Africa ( n 288 above)

<sup>293</sup> Woolfrey (n 261 above)18

### ***Trade triangulation***

Trade triangulation occurs when goods produced under preferential tariff arrangement of an SEZ are allowed into the customs territory of a member of an RTA duty free as a product originating in that member country.<sup>294</sup> The problem that may arise is that it creates a leeway for other products not originating in an RTA member state to enter the RTA duty free thereby infringing on tariff policies of RTA members and possibly eroding the RTA's block against third countries.<sup>295</sup> Thus if SEZ-processed goods from Kenya are allowed to be sold into other EAC countries as originating products of Kenya, then it could open up a possibility that any product not originating in Kenya could enter the EAC free of duties through the SEZs.<sup>296</sup>

Trade triangulation also has a potential of undermining opportunities for Foreign Direct Investment in an RTA.<sup>297</sup> This may happen where, for instance, a regional bloc does not allow entry of duty free goods from an SEZ hence foreign suppliers of inputs to the SEZ operators would have an incentive of establishing their operations within the RTA in order to take advantage of the enlarged market access arising from the regional bloc.<sup>298</sup> On the other hand, where it is possible for SEZ goods to enter the territory free of duty, there would be less incentive for foreign investors to establish their operations within the RTA.<sup>299</sup> Such disincentive for FDI may be a problem to RTA member governments as most if not all governments want to bring in as much FDI as possible.<sup>300</sup>

### ***Competitiveness of local producers***

Another issue with allowing duty free market access in an RTA to SEZ-processed goods has to do with competition with the local producers outside the SEZ. SEZs typically benefit from a range of incentives including duty free import of inputs, tax exemptions and relaxed business regulations which other producers outside of these SEZs do not benefit from.<sup>301</sup> As we saw in chapter 2, Kenyan SEZs have been granted several incentives including tax holidays and duty free inputs.<sup>302</sup> Given this kind of advantage that SEZ producers have over local non-SEZ producers who pay full import duties on inputs and equipment and pays full taxes, allowing

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<sup>294</sup> T Farole *Special economic zones: Progress, emerging challenges and future directions* (2011) 136

<sup>295</sup> Farole (n 293 above) 136

<sup>296</sup> Farole (n 293 above) 136

<sup>297</sup> Farole (n 293 above) 136

<sup>298</sup> Koyama (n 257 above) 136

<sup>299</sup> Koyama (n 257 above) 136

<sup>300</sup> Koyama (n 257 above) 136

<sup>301</sup> Koyama (n 257 above) 137

<sup>302</sup> Farole (n 293 above) 137

duty free market access to SEZ-produced goods would put local producers at a disadvantage against SEZ producers.<sup>303</sup>

Such competitive disadvantage to local producers may lead to stifling of certain local industries or even driving local producers out of business. This is more so disadvantageous where other RTA member countries are involved some of which may not have similar SEZ programmes as the one extending such incentives to its SEZs. In the EAC for instance, only Kenya has established a sizable SEZ programme with other countries' such as Tanzania's zones not having much impact.<sup>304</sup> Allowing duty free entry of Kenyan SEZ-produced goods into the region would therefore put the regional market producers at a disadvantage.

### ***Promotion of regional economic integration***

Related to the issue of competitiveness of local/regional producers is the issue regional economic integration. The two are related in the sense that giving SEZ operators more advantage over local suppliers may threaten the effectiveness of regional body in promoting regional economic integration which in most cases is the primary objective of RTAs.<sup>305</sup> This may happen because conflict between SEZ-based investors and local producers or suppliers is likely to hinder integration of industries across RTA member countries.<sup>306</sup> Where for instance, SEZ operators are allowed to sell their goods to RTA member states' local producers including those involved in trade of inputs and foreign equipment, they are likely to crowd out infant local suppliers.<sup>307</sup> Such a trend may inhibit the RTA from effectively nurturing local producers and supplies and promotion of local vertical industrial linkages.<sup>308</sup>

### ***Positioning of SEZs competitively***

Where on the other hand countries take the approach of promoting regional integration over individual country-based SEZs then SEZ-based firms would lose the relative advantages they enjoyed prior to such integration promotion.<sup>309</sup> Given that most of the fiscal incentives given to SEZ firms are pegged on or linked directly to export performance of those SEZ firms, RTAs essentially turn what had previously been considered as regional export markets into domestic markets thereby limiting their access to these markets.<sup>310</sup> The implication is that the ability of

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<sup>303</sup> Farole (n 293 above) 137

<sup>304</sup> Farole (n 293 above) 137

<sup>305</sup> Koyama (n 257 above) 137

<sup>306</sup> Koyama (n 257 above) 138

<sup>307</sup> Koyama (n 257 above) 138

<sup>308</sup> Koyama (n 257 above) 138

<sup>309</sup> Farole (n 293 above) 138

<sup>310</sup> Farole (n 293 above) 138

these firms to meet their required export specifications, which are the basis of their incentives, is reduced significantly hence reducing the advantages of being based in an SEZ.<sup>311</sup>

#### **4.4 Legal response to SEZ-RTA conflict**

As was mentioned earlier, the above are economic challenges that are posed when RTA and SEZ instruments are used simultaneously by countries. Of great concern is the issue of market access of SEZ produced goods to the domestic market (which comprises the RTA) when SEZ enterprises enjoy duty free import of inputs and equipment as well as other fiscal and regulatory incentives. RTAs have devised different legal approaches in controlling entry of products processed under SEZ schemes into the RTA territory. One such approach is through the application of Rules of Origin whereby an RTA may establish a special rule on how goods from SEZs of RTA member states are to be treated.<sup>312</sup> Regional rules of origin prescribe conditions under which goods are considered to have been produced in that region.<sup>313</sup> For instance, one such condition could be that non-regional inputs undergo some level of ‘substantial transformation’ in the region before they can qualify as originating products according to the terms of the RTA.<sup>314</sup> In such a case, SEZ products are usually not given the status of originating products and hence they do not enjoy preferential treatment within the RTA.<sup>315</sup> In some strict cases, a complete prohibition of entry of goods processed under SEZ schemes is imposed.<sup>316</sup>

A different approach is by setting out a special clause in the Protocol or Agreement establishing the RTA stipulating the kind of treatment SEZ processed goods are to be accorded in the RTA.<sup>317</sup> Such a clause would usually stipulate that SEZ products may not benefit from the status of originating products.<sup>318</sup>

In the following section, as a way of comparison, I will look at how one regional body, the North American Free Trade Agreement (NAFTA), has addressed the issue in respect of SEZ processed goods from Mexico’s Export Processing Zones (known as maquiladoras<sup>319</sup>) before evaluating how the EAC has addressed the same issue. The next chapter will prescribe the best

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<sup>311</sup> Farole (n 293 above) 138

<sup>312</sup> Koyama (n 257 above) 138

<sup>313</sup> J Granados *Export Processing Zones and other special regimes in the context of multilateral and regional trade negotiations* (2003) 5 <http://www.iadb.org/intal> or [www.iadb.org/int](http://www.iadb.org/int)

<sup>314</sup> Granados (n 312 above) 5

<sup>315</sup> Granados (n 312 above) 5

<sup>316</sup> Farole (n 293 above) 139

<sup>317</sup> Koyama (n 257 above) 138

<sup>318</sup> Koyama (n 257 above) 138

<sup>319</sup> The Mexican name for manufacturing operations in a special economic zone

way forward for EAC to enable the region realize the benefit of both SEZs and regional integration.

#### 4.4.1 NAFTA

At the time of the establishment of the North American Free Trade Agreement (NAFTA) in 1994, many academic writers held the view that the elimination of Mexico's Maquiladoras would be inevitable.<sup>320</sup> The view at that time was that with the implementation of the RTA (NAFTA), the regulatory structure supporting the maquiladora industry would cease to exist thereby leading the EPZ industry in Mexico to gradually transition from an 'enclave to an integral part of Mexico's national industry structure.'<sup>321</sup> The issue at the time was that traditionally, maquiladoras were able to import their non-regional inputs into Mexico duty free.<sup>322</sup> Through the use of rules of origin, if their processed products had sufficient regional content to qualify under the NAFTA rules, no duty would be collected on the non-regional inputs when the processed products crossed the border into the United States market and therefor trade deflection became a major challenge.<sup>323</sup>

To address the challenge of trade deflection, it was agreed to refuse entry to goods produced under special regimes benefitting from free trade and duty free import of inputs.<sup>324</sup> The maquiladora firms were however granted a seven year phase-in period during which they continued enjoying duty free import of non-regional production inputs.<sup>325</sup> Article 303 of NAFTA however required that from January 2001, non-regional inputs consumed by maquiladora firms be subjected to Mexico's external tariffs. This provision was however bad news for maquiladora operators given that Mexico maintained high external tariffs on non-regional goods and hence the elimination of duty draw backs/ deferral benefits was likely to seriously decrease the competitiveness of maquiladora firms.<sup>326</sup> Thus eliminating duty deferral benefits may have created an incentive for maquiladora firms to move to EPZ firms outside of NAFTA in order to lower their operating costs.<sup>327</sup>

As a way of preventing maquiladora firms from moving elsewhere, the Mexican government launched what is referred to as 'Sectoral Promotion Programs' whereby if a maquiladora firm

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<sup>320</sup> J Sargent & L Mathews *Combining Export Processing Zones and Regional Free Trade Agreements: Lessons from the Mexican Experience* (2001) 1740 <http://www.elsevier.com/locate/worlddev>

<sup>321</sup> S Weitraub *NAFTA: What comes next?* (1994)

<sup>322</sup> Sargent & Mathews (n 319above) 1740

<sup>323</sup> Sargent & Mathews (n 319above) 1741

<sup>324</sup> Sargent & Mathews (n 319above) 1741

<sup>325</sup> Sargent & Mathews (n 319above) 1741

<sup>326</sup> Sargent & Mathews (n 319above) 1741

<sup>327</sup> Sargent & Mathews (n 319above) 1742

was able to demonstrate that they could not easily substitute inputs from non-NAFTA region with those from NAFTA, then the government would lower external duties on those inputs.<sup>328</sup>

#### **4.4.2 The EAC**

The EAC has in place laws and regulations that deal with treatment of goods produced in special economic zones in the member states. The East African Community Customs Union Protocol together with regulations under it - The EAC Customs Union Regulations, Annex VII on Export Processing Zones and The East African Community Customs Union (Freeport Operations) Regulations, Annex VIII provide for treatment of goods originating in SEZs and EPZs within the EAC region. Under these regulations, existing national legislations on EPZs, Freeports and other forms of SEZs must be aligned with the EAC regulations.

##### ***The East African Community Customs Union Protocol***

The Protocol contains provisions relating export promotion schemes, duty drawback schemes, tax remission schemes, export processing zones, Freeports and tax exemption regimes. Article 25 of the Protocol stipulates that goods produced through export promotion schemes shall be primarily for export outside the community and if sold to the EAC customs territory, they shall be subject to full duties and other charges provided in the EAC common external tariff and such sale shall be limited to only 20% of the company's annual production.<sup>329</sup>

According to Article 31 of the Protocol, goods entering into a freeport are exempt from payment of all duties and import levies except where they are removed from the freeport for home use.<sup>330</sup>

##### ***The EAC Customs Union Regulations, Annex VII on EPZs***

Article 29 of the EAC Customs Union Protocol allows the establishment by member states of EPZs provided that they are operated in accordance with the East African Community Customs Union (Export Processing Zones) Regulations (Annex VII) to the Protocol and the customs law of the Community.<sup>331</sup> The regulations were provided to 'ensure that there is uniformity among the Partner States in the implementation of the provisions on export processing zones and to ensure to the extent possible, that the process is transparent, accountable, fair and predictable.'<sup>332</sup>

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<sup>328</sup> Sargent & Mathews (n 319above) 1742

<sup>329</sup> The East African Community Customs Union Protocol, Article 25

<sup>330</sup> The East African Community Customs Union Protocol, Article 31(3)

<sup>331</sup> The East African Community Customs Union Protocol Article 29 (3)

<sup>332</sup> Annex VII Regulation 2

The regulations define an export processing zone to mean a ‘designated part of the customs territory where any goods introduced are generally regarded, for purpose of import duties and taxes, as being outside the customs territory but are restricted by controlled access.’<sup>333</sup> A customs territory is further defined to mean the geographical areas of the EAC member states.<sup>334</sup> As such, any movement of goods or services from a member state’s EPZ into the customs territory are deemed to be imported into the customs territory and therefore subject to import duties.<sup>335</sup> However, exports to the customs territory from an EPZ is subject necessary permission being granted by the relevant authorities, payment of customs union and not exceeding 20% of the annual production of the exporting company.<sup>336</sup>

***The EAC Customs Union (Freeport Operations) Regulations, Annex VIII***

Article 31 of the EAC Customs Union Protocol allows the establishment by member states of Freeport provided that they are operated in accordance with the East African Community Customs Union (Freeport Operations) Regulations (Annex VIII) to the Protocol.<sup>337</sup> The regulations define a Freeport zone as a ‘a designated area placed at the disposal of the freeport authority where goods introduced into the designated area are generally regarded, in so far as import duties are concerned, as being outside the customs territory.’<sup>338</sup> Goods entering a freeport zone are free from import duties and taxes and are deemed to be outside the customs territory and not subject to the usual customs controls.<sup>339</sup>

In general, the EAC customs union excludes SEZ-processed goods from being treated as products originating in the EAC region.<sup>340</sup> The result of this exclusion is that goods processed in SEZs are not allowed to be sold in the EAC customs territory, and where authorization to sell is granted then only a limited amount of such goods can be sold on condition that applicable import duties and other taxes and charges are paid.

While this was not a major concern previously due to the fact that most SEZ firms in Kenya initially exported most of their products outside the EAC region (mainly Europe and the United States) and were therefore not affected by this limitation, the situation is much different now since Kenya’s full integration into the EAC customs Union has changed the economic justification of many investors leading to more investment intended for the larger EAC

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<sup>333</sup> Annex VII Regulation 3

<sup>334</sup> Annex VII Regulation 3

<sup>335</sup> Annex VII Regulation 14(b)

<sup>336</sup> Annex VII Regulation 14(b)

<sup>337</sup> The east African Community Customs Union Protocol Article 31 (5)

<sup>338</sup> Annex VIII, Regulation 3

<sup>339</sup> Annex VIII, Regulation 9 (1)

<sup>340</sup> Koyama (n 257 above) 142

market.<sup>341</sup> Indeed, there are already requests from many investors in the SEZs to the Kenyan authorities to authorise them to sell more of their products to the EAC market.<sup>342</sup> If such requests are allowed, then the question of how tariffs on SEZ- finished goods allowed in the EAC territory are to be treated will definitely arise as an issue among the EAC member states.<sup>343</sup> The region has not yet addressed this issue in the existing regulations of the Community.

#### **4.5 Is exclusion the best practice?**

While excluding SEZ goods from access to the regional market seems to be a working formula for addressing challenges that could arise from the mixed use of SEZs and RTAs, it is a formula that does not allow the two instruments (SEZs and RTAs) to benefit from each other. In regions where SEZ production makes up a significant portion of intra-regional trade, relatively little of the potential welfare gains from the RTA are likely to be achieved if the SEZ industry is excluded from the RTA.<sup>344</sup> SEZ firms would miss the chance to benefit from the expanded market in the RTA if they are made to operate as exclusive entities.<sup>345</sup> There is therefore sound logic for allowing SEZ firms access to host country as well as regional market.<sup>346</sup>

If SEZ firms were for instance allowed to sell their produce into the regional market, they could create excellent grounds to boost interregional trade and promote regional value chains as well as tighter economic connections between the EAC member countries.<sup>347</sup> This would be a great opportunity to boost intra-African trade which has over the years remained extremely low. Allowing regional sale of SEZ-processed goods would also enable them to take advantage of the various infrastructure developments and initiatives currently being undertaken in the region. For, instance, the government of Kenya is spearheading the development of Lamu Port-South Sudan-Ethiopia-Transport (LAPSSSET) corridor project, an infrastructure project, to strengthen the country's position as "a gateway and a transport and logistics hub to the EAC sub-region and the great lakes region to facilitate trade, promote regional economic integration and inter-connectivity between African countries."<sup>348</sup>

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<sup>341</sup> Koyama (n 257 above) 142

<sup>342</sup> Koyama (n 257 above) 142

<sup>343</sup> Sargent & Mathews (n 319above) 1742

<sup>344</sup> Sargent & Mathews (n 319above) 1742

<sup>345</sup> Sargent & Mathews (n 319above) 1742

<sup>346</sup> Sargent & Mathews (n 319above) 1742

<sup>347</sup> Woolfrey (n 261 above) 18

<sup>348</sup> <http://www.deputyresident.go.ke/index.php/lapest-projects> - accessed on May 31, 2016

However, if SEZ firms are allowed full access to the market of the host country, it would be logic to give them better incentives that other firms outside the SEZ in the regional economy do not benefit from.<sup>349</sup> Similarly, where SEZ firms and non-SEZ firms from the host country or region compete for a share of the same market, to continue to extend preferential treatment to SEZ firms would put the host country's own national firms at a competitive disadvantage.<sup>350</sup> It is this dilemma that has led to the exclusion of SEZ firms and investors from enjoying the benefits of enlarged markets arising from regional integration.

It is on this note that there is a need to harmonize RTA and SEZ programmes in a manner that ensures that there is synergy between them and that they benefit from each other. There is a possibility of developing synergies between SEZ and RTA instruments in a way that can enable SEZ to leverage and promote regional integration.<sup>351</sup> Such synergy can be best achieved through regional regulatory harmonization that goes beyond tariff matters.<sup>352</sup> The next chapter will discuss at length how such regulatory harmonization can be implemented in the East African Community to ensure that Kenya and the region as a whole does not miss out on the potential benefits that can be achieved through a harmonized SEZ-RTA regulatory framework.

By way of emphasis, incentives based on tariffs related to exports that most SEZs employ are particularly problematic given that they inhibit the potential for member countries to take full advantage of potential synergies between RTAs and special economic zone programmes.<sup>353</sup> This way, they encourage the countries employing them to rule out the possible opportunities for SEZ processed goods to enjoy benefits that come with regional integration through RTAs and even in some extreme instances, they completely restrict entry of SEZ processed goods into the regional market to control tariff jumping.<sup>354</sup>

#### **4.6 Conclusion**

As a way of addressing the challenges associated with the conflict between RTAs and SEZ programmes, the East African Community, like many regional bodies has opted to exclude SEZ firms from benefitting from free trade arrangements resulting from regional integration arrangement within the community. Sale of SEZ produced goods in the region has been limited

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<sup>349</sup> Sargent & Mathews (n 319 above) 1742

<sup>350</sup> Koyama (n 257 above) 137

<sup>351</sup> Koyama (n 257 above) 143

<sup>352</sup> Koyama (n 257 above) 144

<sup>353</sup> Koyama (n 257 above) 146

<sup>354</sup> Koyama (n 257 above) 146

by regulation and even where it is allowed, such sale is subject to import duties in accordance with the region's common external tariffs (CET)

The implications of such requirement therefore are that the two instruments (SEZs and RTAs) which are supposed to be employed by the region towards a common goal of promotion of trade and investment are run exclusive of each other thereby not benefitting from each other. The next chapter seeks to find out how these two instruments can be harmonize in a manner that can generate synergy between them in order to enable the region harness their joint strengths and benefits.

## CHAPTER 5

### 5 TOWARDS A HARMONIZED SEZ-RTA FRAMEWORK IN EAST AFRICAN COMMUNITY

#### 5.1 Introduction

In chapter four, the study looked at the challenges that can come up where a country that is pursuing regional integration initiatives also sets up special economic zones in its territory. One major challenge associated with mixed use of RTAs and SEZs as I pointed out in the previous chapter is the issue of how SEZ-processed goods in an RTA member country are to be treated in the region in terms of their access to the regional market. This is due to the fact that while RTAs allow for duty-free movement of goods between their member countries, allowing SEZ processed goods such same freedom would be competitively disadvantageous to other regional non-SEZ firms due to the preferential treatment the SEZ firms enjoy.

To address this challenge, I looked at how different regions and countries have devised ways to ensure that there is no conflict between SEZ firms and local producers by ensuring that SEZ produced goods either do not gain access to the regional market, or if they do have access then they do not do so freely but are subject to custom duties that put them at par with other local non-SEZ producers. This ensures that local or regional producers are not subjected to competitive disadvantage by having to compete for the same market with SEZ goods which are produced under more favourable conditions and lower costs. Such measures can be put in place through regulations under the RTAs establishing Protocol or through the use of Rules of Origin that stipulate that SEZ produced goods are not considered as originating products and hence do not enjoy duty free market access in the region.

The result of such measures is that SEZs are completely excluded from the regional economy and as such cannot benefit from any advantages that accrue from regional integration. Similarly, the region (RTA) cannot make any use of the SEZ as the two programmes are run exclusive of each other. Thus measures by RTAs to control entry of goods produced in SEZ only provide a passive response to the issues that come up when SEZs and RTAs overlap by merely addressing possible risks generated by the SEZs while missing out on the possibility of developing synergies between the two instruments necessary to enable SEZs promote and leverage regional integration.<sup>355</sup>

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<sup>355</sup> T Farole *Special economic zones: Progress, emerging challenges and future directions* (2011) 143

To help develop synergy between SEZs and RTAs, there needs to be efforts by the RTA to harmonize the SEZ programmes among its member countries.<sup>356</sup> Such harmonization needs to go beyond tariff and fiscal issues to other matters that can help integrate SEZ programmes into regional integration arrangements.<sup>357</sup> This chapter therefore explores ways in which the East African Community can harmonize the SEZ programmes in its member countries to ensure that the two instruments generate regional synergies for the community.

## **5.2 Harmonization of SEZ programmes in the EAC**

It is important to note, at the outset, that although there have been some discussions and initiatives towards harmonization of SEZ programmes among the East African Community member countries,<sup>358</sup> in practice not much has been done to materialize such discussions.<sup>359</sup> So far, the EAC customs union has tried to harmonize the regulatory framework on EPZs in the member countries by providing an elaborate Annex to provide a common regulatory framework.<sup>360</sup> The objective of the EPZ regulations was to ensure that the process in relation to EPZ “is transparent, accountable, fair and predictable.”<sup>361</sup> The regulations define the terminologies relating to Export Processing Zones so that these terms are used consistently by all the member states.<sup>362</sup> The regulations further set out activities that are allowed in the EPZs<sup>363</sup>, set up how goods processed in Export Processing Zones are handled when allowed access into the regional territory<sup>364</sup>, they provide for the establishment and function of relevant authorities<sup>365</sup> as well as make provisions for resolution of disputes and complaints.<sup>366</sup>

It is further important to note that these regulations are specific to EPZ and leave out other forms of economic zones like the SEZ programmes that Kenya is currently working to establish. Currently, the Investment Climate Advisory Services (CIC) of the World Bank Group is working with the East African Community Secretariat to enhance its intra-regional trade and part of what they are doing is to offer advisory for SEZ programmes in the region.<sup>367</sup> In 2009,

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<sup>356</sup> Farole (n 354 above)

<sup>357</sup> Farole (n 354 above)

<sup>358</sup> Farole (n 354 above) 144

<sup>359</sup> Farole (n 354 above)

<sup>360</sup> The EAC Customs Union Regulations, Annex VII on Export Processing Zones

<sup>361</sup> Annex VII regulation 2

<sup>362</sup> Annex VII regulation 3

<sup>363</sup> Annex VII regulation 10

<sup>364</sup> Annex VII regulation 14

<sup>365</sup> Annex VII regulation 6, 7 & 8

<sup>366</sup> Annex VII regulation 18

<sup>367</sup> N Koyama, Chapter 6, *SEZs in the Context of Regional Integration: Creating Synergies for Trade and Investment* (2011) 148. Chapter in book *Special economic zones: Progress, Emerging Challenges and Future Directions*

CIC evaluated the SEZ programmes in the region and made preliminary recommendations to the Community and the host governments on harmonization.<sup>368</sup>

### **5.3 Recommendations for harmonization**

As I noted earlier, merely cutting out SEZs and preventing them from selling in the regional market is not the best way to ensure synergies between SEZs and RTAs. While there have been preliminary recommendations for more coordinated harmonization, member countries of the EAC are yet to take any major steps to implement the said recommendations.<sup>369</sup> The following section will look at some of the recommended ways that harmonization can be done to better exploit the complementarities between SEZ and RTA<sup>370</sup>:

#### **5.3.1 Harmonizing Regulations**

Simple and straightforward regulations are an investment incentive in that they make a country attractive for investment by lowering the cost of conducting search and enable investors to comply with the necessary regulations easily.<sup>371</sup> Having simple and straightforward regulations governing SEZs within an RTA is therefore an important step in attracting SEZ investors to a region.<sup>372</sup> Potential investors logically research and compare investment related regulations when exploring a new place where they would want to establish their operations.<sup>373</sup> SEZ investors are also likely to research regulations relating to SEZs across all potential investment destinations in a given region.<sup>374</sup> Several factors such as the existing SEZ law or lack thereof, what is required to establish operations in the zone and application and registration processes are issues that may be of interest to a potential SEZ investor.<sup>375</sup>

As such, having clear and certain SEZ regulations with uniform terms and definitions in all RTA member countries lowers costs associated with search for investors hence more attractive and harmonized regulations may give a region an upper hand in competing against other regions for foreign investment by making it more attractive to investors.<sup>376</sup> Such harmonized regulation even more important in that it allows competition for foreign investment by RTA member countries based on their individual strengths and comparative advantage.<sup>377</sup>

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<sup>368</sup> Koyama (n 366 above)

<sup>369</sup> Koyama (n 366 above) 149

<sup>370</sup> Farole (n 354 above) 144

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<sup>372</sup> Farole (n 354 above) 144

<sup>373</sup> Farole (n 354 above) 145

<sup>374</sup> Farole (n 354 above) 145

<sup>375</sup> Farole (n 354 above) 145

<sup>376</sup> Koyama (n 366 above) 145

<sup>377</sup> Koyama (n 366 above) 145

Naoko Koyama<sup>378</sup> suggests that binding regulations together within an RTA is an added advantage to a member country's government with questionable credibility to investors. The reason for this, he says, is that when regulations are harmonized at the regional level, individual governments are unlikely to change their laws because deviating from the RTA agreement may be more costly than the gains that may accrue from changing a given regulation.<sup>379</sup> Harmonization of regulations therefore provides investors with certain and predictable business environment, an important tool for establishing a lasting and sustainable commercial base in a country.<sup>380</sup>

While harmonized SEZ regulations in a region would bring in many advantages to the region, implementing such integration is however easier said than done given that individual countries inevitably have their own interests.<sup>381</sup> Countries that are economically behind may still want to attract more investment by offering more favourable SEZ rules to enable them catch up with their neighbours even where other countries in the region may already be willing to simplify and harmonize the regional rules.<sup>382</sup> Further, different countries have different levels of political and administrative capacity hence it is only understandable that it would take a long time for all the countries to agree.<sup>383</sup> Harmonization can however be done on a transitional basis by setting up transitional period allowing all members to discuss the ramifications of the proposed changes with its investors and to adjust their national SEZ laws and policies.<sup>384</sup>

The East African Community has taken first strides at unifying the regulatory framework for EPZs as well as establishing competent authorities with similar powers across member countries.<sup>385</sup> There is still however need to harmonize other regulations relating to all other forms of special zones and not just EPZs given that the member countries like Kenya and Tanzania have in place special economic zones programmes that run concurrently with their EPZ programmes. Further, the EAC member states must put in place efforts to effectively build on the unified regulations and integrate their SEZ programmes in order to fully take advantage

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<sup>378</sup> Koyama (n 366 above) 145

<sup>379</sup> Koyama (n 366 above) 145

<sup>380</sup> Koyama (n 366 above) 145

<sup>381</sup> Farole (n 354 above) 145

<sup>382</sup> Farole (n 354 above) 145

<sup>383</sup> Farole (n 354 above) 145

<sup>384</sup> Farole (n 354 above) 145

<sup>385</sup> Koyama (n 366 above) 148

of the benefits of the customs union, accomplish greater regional integration and realize more effective trade and investment.<sup>386</sup>

The ultimate harmonization would however be the establishment of an overall East African Community Special Economic Zones Authority (EACSEZA) to be in charge and oversee the implementation and operation of all the SEZs in the region. The Authority would be in charge of the SEZs with the powers to regulate, monitor and implement all concerning the operations of the special economic zones regime in the region. Such harmonization would help ensure that the SEZ programmes in the EAC region are in harmony with the regional integration initiatives.

Harmonizing SEZ regulations in the EAC region has a potential of not only establishing integrated SEZ rules but also a potential for unifying the overall investment laws among the EAC member countries.<sup>387</sup> Additionally, countries who are still inexperienced in SEZs or whose SEZ programmes are not doing well can take advantage of the experiences of more advanced neighbours through consolidating their programmes.<sup>388</sup>

### **5.3.2 Harmonizing financial incentives**

Countries (especially developing ones) compete for foreign investment by giving greater financial incentives to foreign investors.<sup>389</sup> When doing this, they risk eroding their tax bases with no guarantee that these incentives will result in more investment coming in than they would without them.<sup>390</sup> The result is that most of these countries end up merely transferring rents directly to investors who are usually multinational companies without gaining much in terms of quality investment.<sup>391</sup>

The East African Community member states currently have different levels and structures of financial incentives in their SEZ packages and there have not been major attempts to harmonize these incentives.<sup>392</sup> Such lack of harmonization of financial incentives as I noted in a previous chapter has the potential to lead to a race to the bottom as these countries individually compete to offer as lucrative incentives as possible in the hope of ‘beating their neighbours’ in attracting

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<sup>386</sup> Koyama (n 366 above) 148

<sup>387</sup> Koyama (n 366 above) 149

<sup>388</sup> Koyama (n 366 above) 149

<sup>389</sup> Farole(n 354 above) 146

<sup>390</sup> Farole(n 354 above) 146

<sup>391</sup> Farole(n 354 above) 146

<sup>392</sup> Koyama (n 366 above) 149

foreign investment.<sup>393</sup> The best way forward therefore would be for these countries to collectively lower or remove these financial incentives.<sup>394</sup>

Further, some of the EAC member countries, for instance Kenya, employ export based incentives in their SEZ programmes. Kenya for instance requires that up to 80% of SEZ produced goods be exported for the investor to qualify for tariff incentives.<sup>395</sup> As has already been discussed in chapter four, such export based-tariff related incentives do not allow member countries to take full advantage of possible synergies between SEZ and RTA programmes as they prevent SEZ processed goods from enjoying benefits of RTA.<sup>396</sup> Thus countries need to weigh the advantage of promoting investment through financial incentives against the lost opportunities from synergy with the RTA as well as potential loss of their tax bases.<sup>397</sup>

Unifying or removing financial incentives among member countries is not an easy step given that some countries may get pressure from potential and existing investors to give incentives while also where some member countries have established SEZ programmes with financial incentives packages granting some investors permanent exemption of taxes, the process may take time.<sup>398</sup> The benefits of unifying or collectively removing financial incentives would however be greater. Take for example Mexico, which managed, in its membership in NAFTA, to eliminate the most problematic form of export-based financial incentives by moving its incentive programmes from those based on export performance to other types of requirements such as employment creation and amount of investment.<sup>399</sup>

### **5.3.3 Establishing joint strategic frameworks as a region**

The East African Community can establish integrated strategic frameworks for SEZ programmes of its member states.<sup>400</sup> This is not only possible in terms of establishing rules regulations relating to financial incentives but even more widely by enabling them “to complement each other’s resources and capacities and cooperate to achieve shared goals.”<sup>401</sup> Integrating strategic frameworks can be in the form of developing regional manufacturing or services linkages using the SEZs as hubs; jointly marketing the region as an investment

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<sup>393</sup> See discussion in chapter 3

<sup>394</sup> Farole (n 354 above) 146

<sup>395</sup> Farole (n 354 above) 146

<sup>396</sup> Farole (n 354 above) 146

<sup>397</sup> Koyama (n 366 above) 146.

<sup>398</sup> Koyama (n 366 above) 146.

<sup>399</sup> Farole (n 354 above) 146.

<sup>400</sup> Koyama (n 366 above)149.

<sup>401</sup> Farole (n 354 above) 146.

destination; and “specialization of SEZs based on comparative advantage relative to other RTA” member states.<sup>402</sup>

### ***Creation of industrial linkages among SEZs in East Africa***

The EAC member countries can help their industrial sectors take advantage of the improved infrastructure resulting from SEZ development and regional integration depth by coordinating and combining efforts to strategically foster “SEZ based clusters that take advantage of complementary endowments of the different member states.”<sup>403</sup> This can also help these countries overcome limitations of scale and specialization.<sup>404</sup> If countries integrate regional value chains within SEZs, it might also help towards achieving deeper regional economic integration among them.<sup>405</sup>

The East African Community and its donors have invested immense resources on transportation infrastructure to ease movement of goods by regional producers to markets.<sup>406</sup> Further, a significant number of the EAC zones are based close to the major transport facilities such as airports, sea ports and railway lines.<sup>407</sup> The member countries can therefore leverage the improved transport facilities that facilitate more cost effective logistics within the region thereby developing regional industrial linkages through their SEZs in this manner.<sup>408</sup> The Investment Climate Advisory Services (CIC) of the World Bank Group noted that currently, manufacturers in SEZs in the region have minimal commercial dealings among them and hence their scope of specialization is limited.<sup>409</sup> As such, CIC recommended that the East African Community countries consider developing regional linkages given the vast upgrading of their infrastructure networks that allow easy and more cost effective transport among their zones.<sup>410</sup>

### ***Jointly marketing the region as an investment destination***

In addition to creating industrial linkages among SEZs in the region, the EAC member countries should work towards cooperating in branding and marketing of the SEZs in the region. This should be a joint initiative through co-branding and co-marketing.<sup>411</sup> The EAC member

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<sup>402</sup> Farole (n 354 above) 146.

<sup>403</sup> Farole (n 354 above) 146.

<sup>404</sup> Koyama (n 366 above) 146.

<sup>405</sup> Koyama (n 366 above) 146.

<sup>406</sup> S Woolfrey *Special Economic Zones and Regional Integration in Africa* (2013) 18.

<sup>407</sup> Woolfrey (n 405 above).

<sup>408</sup> Woolfrey (n 405 above).

<sup>409</sup> Koyama (n 366 above) 148.

<sup>410</sup> Koyama (n 366 above) 148.

<sup>411</sup> Farole (n 354 above) 147.

countries can therefore promote FDI typically by exhibiting the possibility to access the wider regional market as opposed to a single country's SEZs. It of course would even be more cost effective especially to smaller countries with limited resources on their investment promotion budgets, if the countries could advertise the region's SEZs collectively as investment destinations.<sup>412</sup> Such joint marketing could particularly be practical for priority sectors such as ICT and energy given that such sectors are of great importance for all the member countries and considering the small size and resources of each country.<sup>413</sup> Further, only one or two of these countries have great potential in these sectors and hence there is room for specialization which would make such joint strategies easy.

It does not however escape the mind that such joint initiatives are not easily achieved as it is easier said than done. This is more because SEZ programmes are in most cases intended as pilot tests for promotion of investment policies for single countries with limited resources and such countries intend to achieve immediate results.<sup>414</sup> Coordination of many countries towards joint marketing would however take long hence going against the intention for quick gains.<sup>415</sup> It is therefore necessary that a region considering harmonization of marketing strategies take into consideration the need to balance between quick returns and long term strategy as well as transition between from a stand-alone policy of a single country to a regional policy involving several countries.<sup>416</sup>

### ***Specialization of SEZs based on comparative advantage***

The East African Community countries are endowed in different ways and areas. Building on each country's comparative advantage relative to other EAC member states and establishing SEZs based on these strengths would be a good way of harmonizing and integration of SEZ programmes in the region. It is also through specialization that the region will be able to highlight activities and products on which the region's development partners should focus their industrial development initiatives.<sup>417</sup> Such specialization would also make it easy for the member states to jointly market the regional SEZs as investment destinations without each country harboring any selfish interest.<sup>418</sup> Further, specialization would help prevent issues such as unhealthy competition for foreign investment and the race to the bottom in giving fiscal

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<sup>412</sup> Farole (n 354 above) 147.

<sup>413</sup> Farole (n 354 above) 147.

<sup>414</sup> Farole (n 354 above) 147.

<sup>415</sup> Farole (n 354 above) 147.

<sup>416</sup> Farole (n 354 above) 147.

<sup>417</sup> Woolfrey (n 405 above) 17.

<sup>418</sup> Farole (n 354 above) 147.

incentives as countries will not be in competition with each other for investment but will be working together as a region in bringing in investment targeting different sectors across the region.

#### **5.4 SEZ as regional production hubs**

While SEZs are many a times seen as posing challenges to regional integration initiatives, the simultaneous use of SEZs and regional integration processes also present potential synergies that can be exploited by countries pursuing such strategies.<sup>419</sup> One way of exploiting such synergy is by using SEZs as components of “regional industrial policy to facilitate regional production scale and promote regional value chains.”<sup>420</sup> The East African region like many other African regions face a lot of difficulty in scaling up locally manufactured products and exports but the use of SEZs as platforms for production for the regional market can be a way of easing such difficulties.<sup>421</sup> For SEZs to be used in this manner, however, the regional and national regulations must allow for SEZ-processed goods to be sold in the regional markets.

Further, the region could use the SEZs as source locations for regional inputs for regional as well as global value chains.<sup>422</sup> This would be better achieved if the regional SEZs specialize on their comparative advantages.

The United Nations Industrial Development Organization (UNIDO) in its report proposed that “SEZs may be more relevant as spatial tools for industrial development than as tools of trade policy reforms.”<sup>423</sup> This suggestion was based on the argument that SEZs provide a “clear focus for government investment and institutional reforms” and that SEZ firms especially those concentrating on production for exports are subject to the ‘efficiency test’ of being able to export.<sup>424</sup> Based on this argument, the use of SEZs as a spatial industry policy instrument would only be viable at the regional level if zones are not used as an attempt to bring in investment to areas which are economically isolated within a region.<sup>425</sup> It would however be successful if SEZs are based in urban industrial areas or near major transport corridors such as airports and

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<sup>419</sup> Woolfrey (n 405 above) 18

<sup>420</sup> Woolfrey (n 405 above) 17

<sup>421</sup> Woolfrey (n 405 above) 17

<sup>422</sup> Woolfrey (n 402 above) 17

<sup>423</sup> UNIDO *Industrial Development Report 2009: Breaking in and moving up – new industrial challenges for the bottom billion and the middle income countries* (2009) 73

<sup>424</sup> UNIDO (n 422 above)

<sup>425</sup> Woolfrey (n 405 above) 18

seaports in order to take advantage of “thicker labour markets” and better infrastructure.<sup>426</sup> Such strategies are better able to make SEZs generate useful spill over effects for the region.<sup>427</sup>

## **5.5 Conclusion**

In conclusion, the use of SEZ in countries that are at the same time pursuing regional integration processes has for a long time been perceived to be challenging for reasons that have been highlighted above. Many regions and the East African Community as well have opted to have the two instruments (SEZs and regional integration arrangements) run mutually exclusive of each other in order to avoid any conflicts that may arise. However, the simultaneous use of regional integration and SEZ based industrial development can present potential synergies that can prove beneficial to a region. For such synergies to be exploited, joint efforts at harmonization of SEZ programmes in the member states have to be pursued. Such harmonization goes beyond harmonization of regulations to harmonization of incentives; establishing joint strategic frameworks as a region; creation of industrial linkages among SEZs in the region; joint marketing of the regional SEZs as investment destinations; to specialization of SEZs based on comparative advantage.

Such in-depth harmonization is not easy to achieve due to various self-interests yet if the member states put their minds together and opt to target the long term gains that are bound to accrue from SEZ-RTA synergies as opposed to short term successes of individual countries then it would be possible to make these strides and achieve these gains.

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<sup>426</sup> UNIDO (n 422 above)

<sup>427</sup> Woolfrey (n 405 above) 18

## CHAPTER 6

### 6 CONCLUSIONS AND RECOMMENDATIONS

#### 6.1 Summary of findings

This study has concluded that SEZs and RTAs are important policy instruments employed by many governments to help achieve several economic goals such as attract foreign direct investment as well as improve their international and local trade performance. Used on their own and if successfully implemented, SEZs can generate several gains for the employing government through creation of employment opportunities, attraction of foreign direct investment, transfer of technology and skills among other advantages. To achieve the objective of bringing in investment and reaping the fruits of SEZs, most governments have in place lucrative incentive packages for SEZ investors ranging from improved and relaxed business and regulatory environment to fiscal incentives such as tax exemptions and duty free imports.

Similarly, as a policy tool on their own rights RTAs help countries to come together and overcome challenges that are associated with small and fragmented markets<sup>428</sup> and have advantages such as enlarged markets, better negotiation powers and increased economies of scale.

Kenya has embarked on establishment of special economic zones as a way to boost its economic growth and bring in the much needed foreign direct investment. At the same time Kenya is involved in various regional integration initiatives of which this study focused on the East African Community in which Kenya is an active and key member.

While the relationship between SEZs and RTAs is often seen as conflicting and SEZs seen as posing challenges for regional integration processes for the reasons discussed in this study, the use of both regional integration arrangements and SEZs at the same time can also present potential synergies that can be exploited by a region such as the East African Community if well implemented.<sup>429</sup> For instance, SEZs can be used as part of a regional industrial policy to boost production scales at the regional level and help in promoting and integrating regional value chains.<sup>430</sup> Further, given the challenges the East African Community countries face in scaling up locally manufactured produce and exports, SEZs are potential platforms for regional, sub-regional and local markets if domestic regulations and regional laws can authorize sale of

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<sup>428</sup> C Peters – Berries *Regional Integration in Southern Africa: A Guide Book* (2010) 13

<sup>429</sup> S Woolfrey *Special Economic Zones and Regional Integration in Africa*, (2013) 17

<sup>430</sup> Woolfrey (n 429 above) 17

SEZ-produced goods to these markets.<sup>431</sup> This would also put the SEZ firms at a better position to benefit from the various advantages associated with regional integration and infrastructure developments associated with the LAPSSET programme in the region which aims to facilitate trade among the EAC member countries.<sup>432</sup>

For these gains to be achieved however there is need for harmonization of the SEZ programmes of the various EAC member states.

## **6.2 Conclusion**

The simultaneous use of SEZs and regional integration initiatives by Kenya presents potential opportunities that can be exploited by the country to achieve some of its economic and development goals. Such gains can however only be achieved if there is harmony in the regulatory framework for SEZs at the national level and at the regional level as well as through establishing joint strategic frameworks for SEZs as a region. As it is right now SEZs in Kenya are in a mutually exclusive relationship with regional integration initiatives and the two instruments are not drawing much benefit from each other as SEZ firms have limited access to the regional market.<sup>433</sup> This however need not be the case as there is potential for a more mutually inclusive SEZ-RTA relationship and synergy between the two instruments through harmonization of SEZ programmes in the region.

## **6.3 Recommendations**

The East African Community has made attempts at harmonizing the various SEZ schemes in the region. This can be seen through the regulations under the East African Community Customs Union Protocol. The EAC Customs Union Regulations, Annex VII on Export Processing Zones and the East African Community Customs Union (Freeport Operations) Regulations, Annex VIII are meant to bring a certain level of uniformity in the operations of EPZs and Free-ports in the region. As such, we can say that the EAC has made first steps of ensuring that the regulatory framework underlying special economic zones in the region is harmonized.

While these efforts are commendable, there is still room for improvement in terms of harmonizing the regulatory structure for all forms of economic zones in the region and not just freeports and EPZs. This is because the EAC member countries operate various forms of zones

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<sup>431</sup> Woolfrey (n 429 above)

<sup>432</sup> Woolfrey (n 429 above)

<sup>433</sup> N Koyama, Chapter 6, *SEZs in the Context of Regional Integration: Creating Synergies for Trade and Investment*, (2011) 149. Chapter in book *Special economic zones: Progress, Emerging Challenges and Future Directions*

that go beyond SEZs and Free-ports. As such, a unified regulatory framework for the various forms of SEZs would be a significant step to ensuring harmony in the operation of these zones in the region as well as ensuring synergy between these SEZs and regional integration in East African Community.

The ultimate harmonization would however be the establishment of an overall East African Community Special Economic Zones Authority (EACSEZA) to be in charge and oversee the implementation and operation of all the SEZs in the region. The Authority would be in charge of the SEZs with the powers to regulate, monitor and implement all aspects of the SEZs regime in the region. Such harmonization would help ensure that the SEZ programmes in the EAC region are in harmony with the regional integration initiatives.

In addition to the harmonization of the SEZ regulatory framework in the region, this study made recommendation for the following forms of harmonization:

- Harmonization of financial incentives given by the various member states to the SEZ investors. Ultimately, the governments should act in unity to reduce or remove these financial incentives;
- Establishing strategic framework for SEZs as a region, including:
  - Jointly marketing the region as an attractive destination for investment;
  - Creating industrial linkages among the SEZs in the region;
  - Specializing the SEZs based on comparative advantage relative to other regional members;

Such harmonization would help the region maximize on the opportunities presented by SEZ and regional integration initiatives and would help develop synergy between SEZ and RTA instruments in the region.

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