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Economic Commission for Africa

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The African Continental Free Trade Area:

Impact Assessment for Kenya

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Impact Assessment for Kenya

United Nations Economic Commission for Africa

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Contents

Summary

The AfCFTA presents a unique opportunity for Kenya to:

- Bolster its intra-African trade and investment;
- Improve prospects for export diversification through increased demand for manufactured goods;
- Accelerate its industrialization in line with the *Vision 2030*, the *Kenya Industrial Transformation Program* and most recently, the *Big Four Agenda;*
- Enhance food productivity and security as per the goals of the *Big Four Agenda;*
- Boost outward FDI by Kenyan firms towards the rest of the continental market.

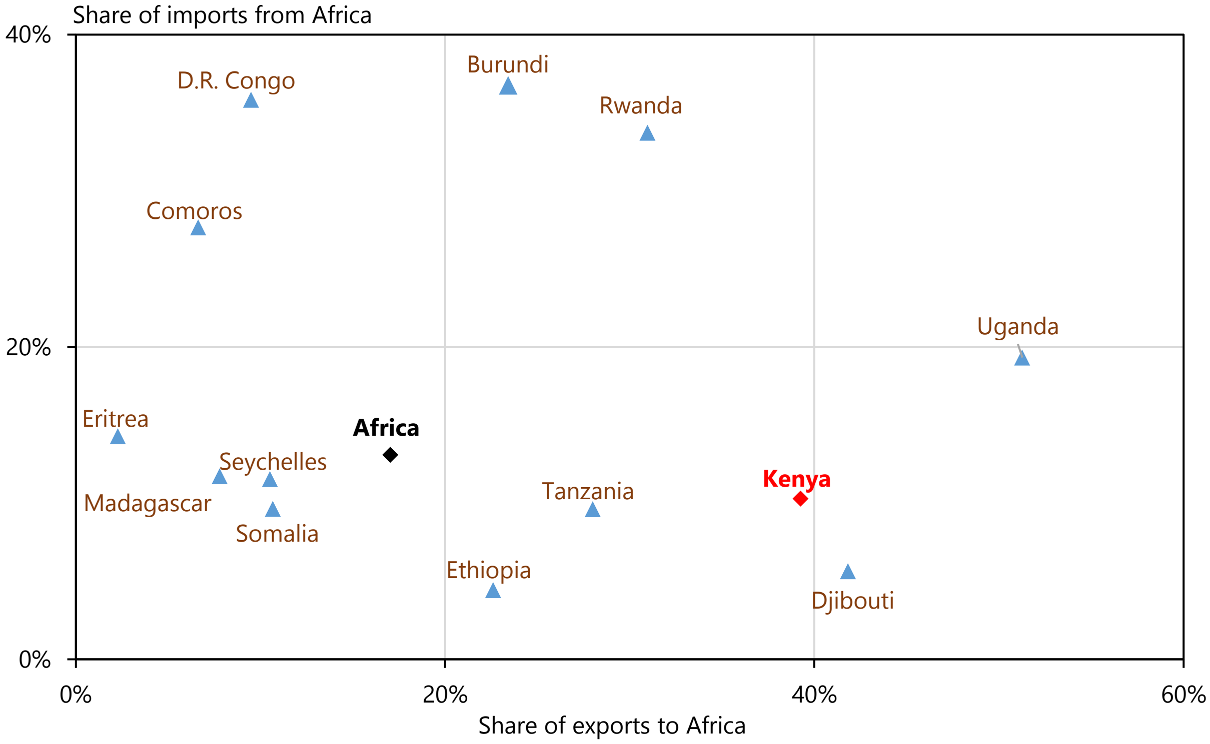
This study finds that, once implemented, the AfCFTA will:

- Increase Kenya's intra-African exports by between USD 140 and 180 million, with petroleum and manufacturing sectors being the main beneficiaries;
- Boost trade and investment with neighbouring Ethiopia;
- Expand imports from other African countries by between USD 68 and 422 million, principally from South Africa;
- Provide a net welfare gain of USD 128 million for the Kenyan economy, particularly through lower prices for Kenyan consumers.

1. Why the AfCFTA is Critical for Kenya

The African Continental Free Trade Area (AfCFTA) will increase Kenya's intra-African trade by reducing the tariff and non-tariff barriers on its trade with African countries. The country's exports to the continent represent 40 percent of its total exports, with more than half of these destined to the East African Community (EAC) Partner States (Figures 1 and 2). Yet Kenya's intra-EAC exports have recently been declining - its intra-EAC exports peaked in 2012 at USD 1.6 billion, but by 2017 had fallen to USD 1.1 billion. Moreover, the country barely trades with its neighbor Ethiopia as the annual exports amount to just USD 70 million (Figure 2). The AfCFTA presents a unique opportunity for Kenya to bolster both its intra-African trade and investment, especially during a time when the global trading environment is looking decisively less stable.[1]

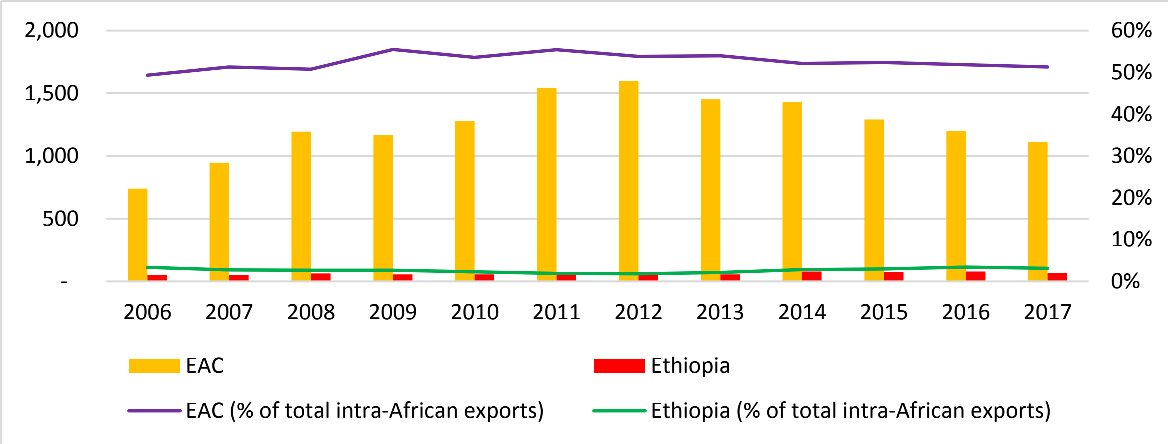
Figure 1: Share of Kenya's Merchandise Trade Flows with Africa, 2015-2017 average



Source: UNCTADStat (2018)

[1] The on-going trade war between the two largest trading nations in the world, the United States and China, is evidence of this, but it is not confined to this case. European integration is being destabilised by the possible imminent exit of the United Kingdom, and there are rising trade tensions between the United States and Europe (UNECA, 2019a).

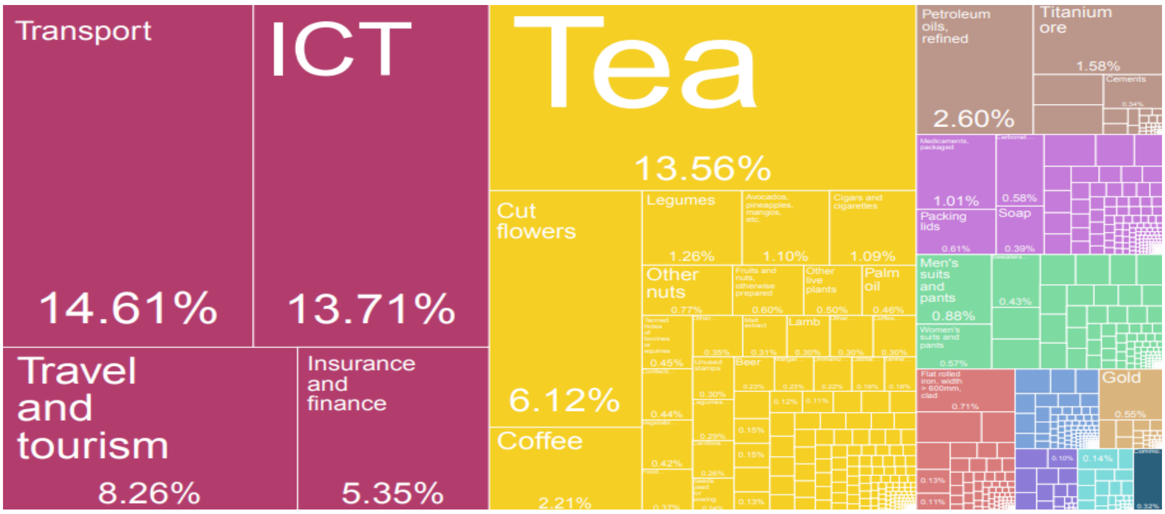
Figure 2: Kenya's Merchandise Exports to EAC and Ethiopia (USD millions and %)



Source: EAC (2016) and KNBS (2011, 2015a and 2019a)

Not only will the AfCFTA boost Kenya's trade volumes with other African trading partners, but it will also improve the prospects for export diversification by increasing the demand for manufactured goods exports. The country has generally performed poorly in terms of trade diversification, with exports concentrated in services[2] and primary (mostly low value-added) commodities, while the manufactured goods exports remain limited (Figure 3 and Kimenyi et al., 2016: 115). Economists (Hausman et al., 2007; Imbs and Wacziargs 2003; Fosu, 1990, 1996 and 2002) have long argued that the composition of exports matters for growth and those countries that export a higher share of manufactured products grow faster than countries that export a low share of manufactured products, a relationship which appears particularly strong for African countries (Fosu, 1990, 1996 and 2002). The AfCFTA will augment Kenya's *Integrated National Export Development and Promotion Strategy* which aims to expand and diversify the country's export products.

Figure 3: Kenya's Exports by Sector (%), 2017



Source: Harvard (2019)

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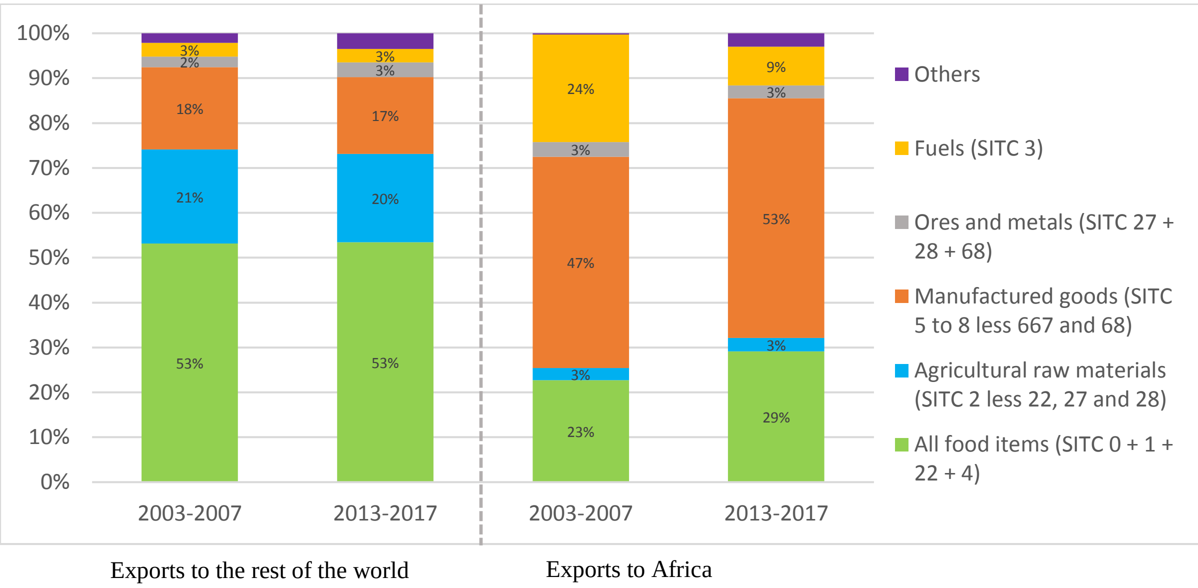
[2] Rodrik (2015) posits that developing countries are experiencing "premature deindustrialization" whereby the manufacturing sector has begun to shrink (or is on course for shrinking) at levels of income that are a fraction of those at which the advanced economies started to de- industrialize. These developing countries are turning into service economies without having gone through a proper experience of industrialization.

Moreover, since manufactured goods dominate Kenya's intra-African exports, in stark contrast to its exports of mainly unprocessed primary commodities to the rest of the world (Figure 4), the AfCFTA presents a unique opportunity to accelerate the country's industrialization in line with its *Vision 2030*, the *Kenya Industrial Transformation Program* and most recently, the *Big Four Agenda.* This is particularly important since Kenya's manufacturing value-added (MVA) as a share of total gross domestic product (GDP) has declined from 12 percent in 2011 to 8 percent in 2018 (WDI, 2019), yet the *Big Four Agenda* pillar on manufacturing has a target of 20 percent of GDP by 2022. The greater intra-African trade in intermediate manufactured goods may also provide a major boost to the competitiveness of the country's domestic firms and producers and facilitate their integration into both the continental and global value chains.[3]

Figure 4: Composition of Kenya's Exports by Main Products (%)



Source: UNCTADStat (2019)

The larger African market envisioned under the AfCFTA, coupled with trade policies that take into account seasonal differences and varying states of food security, will allow greater flexibility in shifting food supplies from surplus regions to Kenya whenever it is facing deficits (UNECA, 2019a).[4] The flagging productivity of cereal crops such as maize, wheat and rice, and climate variability is increasingly becoming a threat to the country's agricultural output with negative implications for food security (World Bank, 2019a:22). The perishable nature of many agricultural food products means that their trade could be particularly responsive to improvements in customs clearance times and logistics expected from AfCFTA implementation (ARIA VIII, 2017:75). Furthermore, Kenya's agricultural sector is characterized by inadequate use of yield-enhancing practices and technologies (World Bank, 2019:28 and KIPPRA, 2017). With the AfCFTA in place, access to agricultural inputs and intermediates (e.g. improved seed varieties and machinery) should improve, thereby improving yields and reliability and enhancing food productivity (UNECA, 2019a). This will go a long way in contributing to the *Big Four Agenda* pillar on food security which aims to attain 100 percent nutritional and food security for all Kenyans by 2022.

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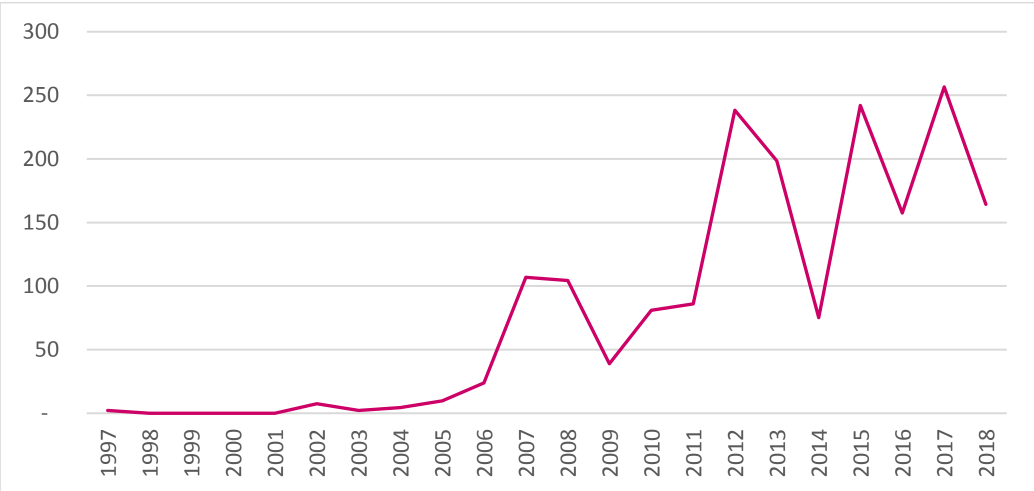
[3] See Section 2.1 of UNECA (2019a) for more detailed discussions.

[4] This was the case in 2016/17 when Kenya suffered adverse climatic conditions but was able to supplement its food demand partially through greater imports from neighbouring Tanzania and Uganda, but also from as far afield as South Africa (KNBS, 2018).

The AfCFTA will boost Kenya's outward foreign direct investment (FDI) by providing incentives for firms to expand beyond the domestic market. Since the transition from single party system in 1991 and peaceful change in government in 2002[5], Kenya's FDI outflows have exhibited an upward trend, increasing from an average of around half a million USD in the period 1997 to 2001 to an average of almost USD 180 million between 2014 and 2018 (Figure 5). Recent estimates from the *Foreign Investment Survey* (KNBS, 2019:31) indicate that Africa accounts for more than 90 percent of Kenya's total FDI outflows. Similar to the trend in merchandise trade, EAC is the major destination of Kenya's intra-African FDI flows. The country is in fact among the top five sources of FDI for some of the EAC Partner States (Figure 6). Nevertheless, there are remarkable business opportunities on the continent that domestic firms can tap into under the AfCFTA.[6] This could contribute very positively to the sectoral diversification of the FDI outflow. At the moment, the only truly regionalized industry is finance – dominated by Kenyan banks, four of which are among the top ten companies in EAC by market capitalization (Figure 7).[7]

The investment policy landscape in Africa is characterized by a "spaghetti bowl" of overlapping bilateral and regional treaties with inconsistent provisions (ARIA IX, 2019: 173). Regional Economic Communities (RECs) such as COMESA and EAC, of which Kenya is a member, have acknowledged this regulatory weakness and partly tried to address it by promulgating common investment regulation as well as model laws and agreements (Paez, 2017: 401). Thus, the AfCFTA protocol on investment presents a valuable opportunity to harmonise the continent's investment regime into one with more transparent, consistent and predictable investment regulations.

Figure 5: Evolution of Kenya's Total FDI Outward Flows (USD millions)



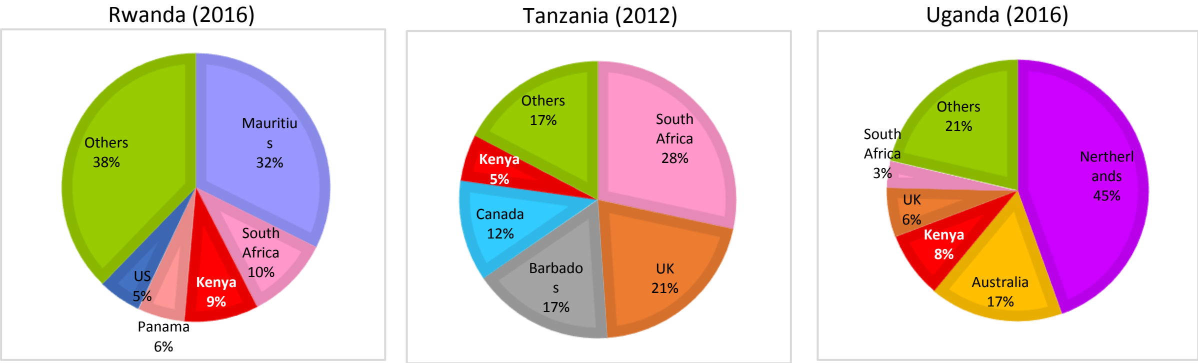
Source: UNCTADStat (2019)

[5] The National Alliance Rainbow Coalition (NARC) under H.E. Mwai Kibaki took over from the Kenya African National Union (KANU) regime under H.E. Daniel arap Moi, who had been in power for 24 years.

[6] In principle, domestic investors have a more intimate knowledge of regional markets and are more capable of navigating the cultural factors that can sometimes impede foreign investment from further afield – there is, in other words, a greater cultural affinity which facilitates cross-border business (Blonigen and Piger, 2014).

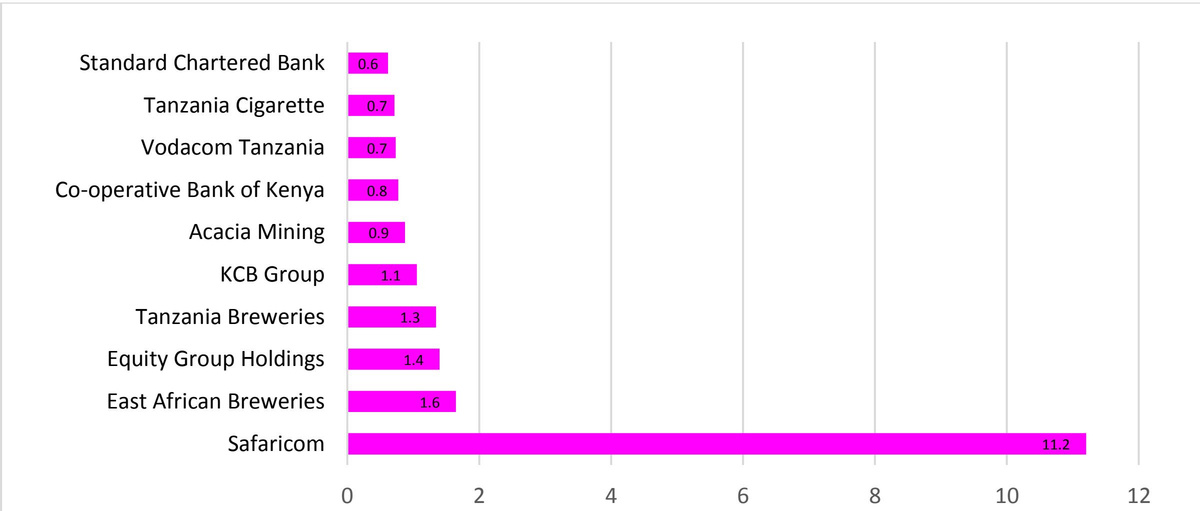
[7] See Mold and Bagiza (2016) for a detailed discussion.

Figure 6: Top FDI Stock Source Countries for Select EAC Partner States (%)



Source: BNR/RDB/ NISR/PSF (2018); BoT (2013) and BoU (2017)

Figure 7: The EAC's Largest Firms by Total Market Capitalization (USD billions), 2018



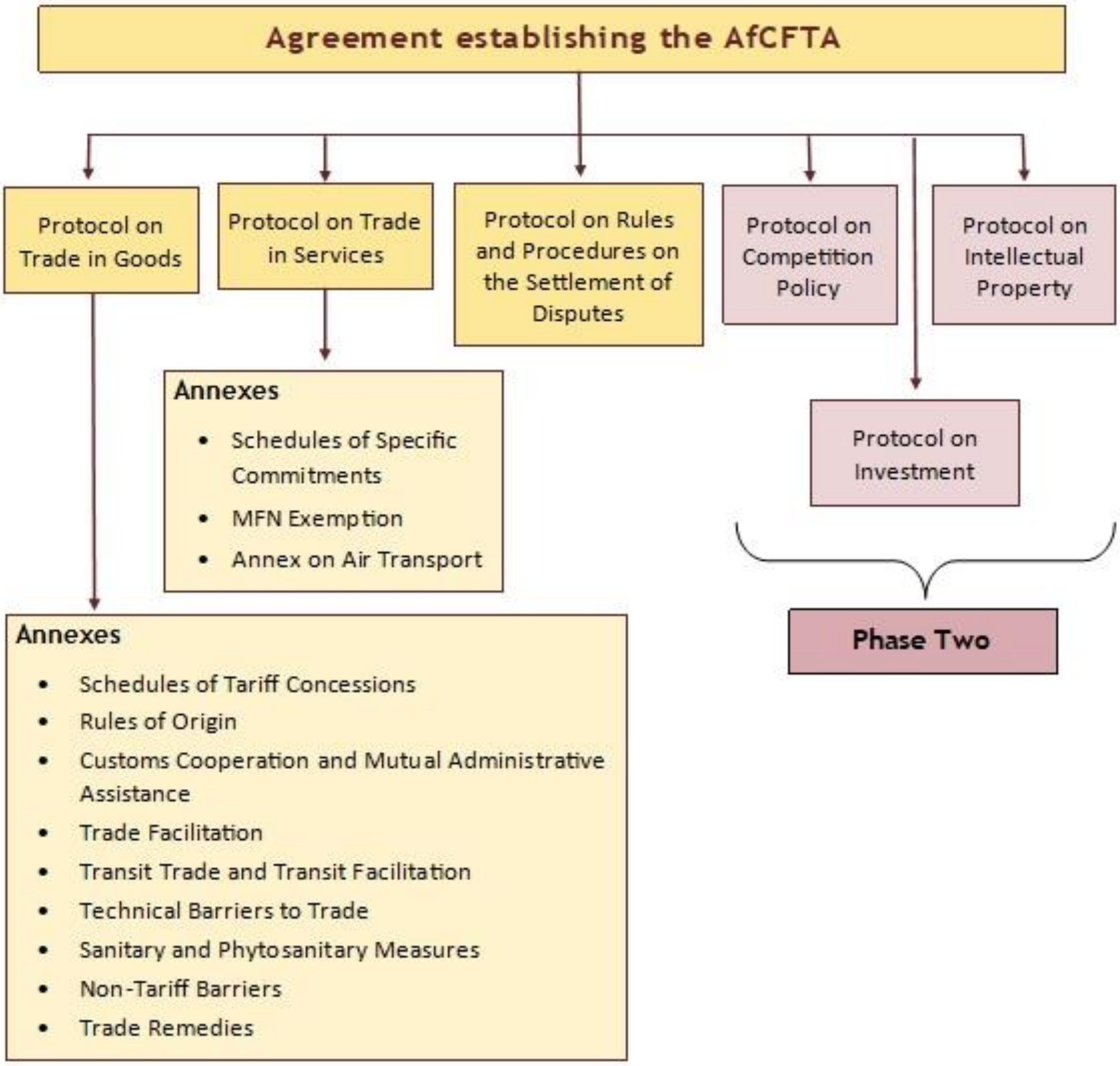
Source: African Business Magazine (2019)

2. What is the African Continental Free Trade Area?

The African Continental Free Trade Area (AfCFTA) will potentially cover the 55 Member States of the African Union, making it the world's largest free trade area (by the number of participating countries) since the formation of the World Trade Organization in 1994. To date, 54 Member States have signed the agreement – something that represents a remarkable degree of consensus in a large, diverse continent.[8] It is called a 'free trade' area, but its scope is wider than that of a traditional free trade area. The main objectives of the AfCFTA are to create a single continental market for goods and services, with free movement of business persons and investments, and lay the foundations for the establishment of a Continental Customs Union.

[8] The speed of the negotiation has been quite remarkable and much faster than in other regions. For instance, Free Trade area negotiations between the European Union and Canada took eight years. Similarly, negotiations between the 34 countries involved in the Free Trade Area of the Americas took 12 years and was never successfully concluded.

Figure 8: Structure of the AfCFTA



Source: TRALAC (2019)

According to *Article 4* of the AfCFTA, for purposes of fulfilling and realizing the objectives of the agreement, Member States shall:

- Progressively eliminate tariffs and non-tariff barriers (NTBs) to trade in goods;
- Progressively liberalize trade in services;
- Cooperate on investment, intellectual property rights and competition policies;
- Cooperate on all trade-related areas between State Parties;
- Cooperate on customs matters and the implementation of trade facilitation measures;
- Design a mechanism for the settlement of disputes concerning their rights and obligations; and
- Establish and maintain an institutional framework for the implementation and administration of the Continental Free Trade Area.

Article 8 of the agreement says that, the Member States that belong to Regional Economic Communities (RECs), which have already attained higher levels of elimination of customs duties and trade barriers, shall maintain, and where possible improve upon, the higher levels of trade liberalization among themselves). As a member of the East African Community, it is thus particularly important that Kenya moves forward with other Member States towards the implementation of the AfCFTA together. Additionally, *Article 19* of the AfCFTA Agreement states explicitly that the RECs will co-exist under the AfCFTA[9] (AU, 2018).

When will the AfCFTA come into force? In line with *Article 23 and 24* of the agreement, the AfCFTA entered into force on 30 May 2019 for the 24 countries that had deposited their instruments of ratification with the chairperson of the African Union Commission.[10] Subsequently, the operational phase of the African Continental Free Trade Area (AfCFTA) was launched during a summit of Heads of State and Government of the African Union (AU) in Niamey, Niger on July 7, 2019. The five operational instruments governing the agreement launched at the meeting include: well-defined Rules of Origin, an online negotiating forum, an online continental non-tariff barrier monitoring and elimination mechanism, a Pan-African platform for digital payments and settlement as well as an African trade observatory portal (AU, 2019a and 2019b).

Nonetheless, critical features of the agreement, including schedules on tariff concessions and commitments on trade in services and policies around investment, intellectual property and competition are still outstanding. Without these elements, there cannot be any trade under the AfCFTA. This implies that trade will continue under the MFN rules of the WTO or as provided for by specific Regional Economic Community (REC) arrangements until trading under the AfCFTA commences (anticipated for 1st July 2020). All this implies that there are a lot of items to be negotiated and that the negotiations will touch on many different areas of economic policy and ministerial competence for Kenya. As a consequence, it is important that a cross-ministerial team looks at the potential implications and come to a consensus on the position to be taken during the negotiations.

How are the tariff concessions being negotiated? The African Union Member States have agreed to remove 90 percent of their tariffs on goods over a period of between 5 and 15 years, depending on whether a country is classified as developing or least developed, with special and differentiated treatment for the group of six countries[11] (Table 1). The 10 percent of goods classified as sensitive or excluded may be liberalized or exempted from any tariff reductions over longer time frames. The designation of sensitive products and exclusion list is on the basis of the following criteria: food security, national security, fiscal revenue, livelihood and industrialization (AU, 2019c: 2).

However, the percentage of sensitive products may not exceed 7 percent of total tariff lines and the exclusion list may not exceed 3 percent of total tariff lines. The application of these percentages is subject to double qualification and anti-concentration clauses where the excluded products shall not exceed 10 percent of total import value from other Member States (This implies that the products to be excluded from liberalization will represent no more than 3 percent of tariff lines accounting for no more than 10 percent of the value of imports from other African countries). This is to avoid exempting entire sectors from tariff cuts (AU, 2019c: 2).

[9] See ARIA IX (2019:48-55) for detailed discussion on the role of the RECs in the AfCFTA negotiating process.

[10] The 24 countries are Ghana, Kenya, Rwanda, Niger, Chad, Congo Republic, Djibouti, Guinea, eSwatini (former Swaziland), Mali, Mauritania, Namibia, South Africa, Uganda, Ivory Coast (Côte d'Ivoire), Senegal, Togo, Egypt, Ethiopia, The Gambia, Sierra Leone, Saharawi Republic, Zimbabwe and Burkina Faso (TRALAC, 2019).

[11] Initially, Djibouti was part of the group, making it the group of seven countries. After consultations, Djibouti agreed to the 90% level of ambition (AU, 2019c: 4)

Table 1: Schedule of Liberalisation Envisaged Under the AfCFTA

<table>
<tr><th></th><th></th><th colspan="3">Tariff Reductions</th></tr>
<tr><th></th><th></th><th>For non-sensitive products</th><th>For sensitive products</th><th>For excluded products</th></tr>
<tr><td rowspan="3">Country classification</td><td>Developing countries</td><td>Fully liberalised over 5 years (linear cut)</td><td>Fully liberalised over 10 years (linear cut)</td><td>No cut</td></tr>
<tr><td>Least developed countries</td><td>Fully liberalised over 10 years (linear cut)</td><td>Fully liberalised over 13 years (linear cut)</td><td>No cut</td></tr>
<tr><td>Group of six (i.e. Ethiopia, Madagascar, Malawi, Sudan, Zambia and Zimbabwe)</td><td>85% liberalised over 10 years (linear cut); an additional 5% liberalised over 15 years (linear cut)</td><td>Fully liberalised over 13 years (linear cut)</td><td>No cut</td></tr>
</table>

Source: Adopted from UNECA (2019). Note: After consultations, Ethiopia, Madagascar, Zambia and Zimbabwe agreed to the level of liberalization of 90% to be implemented over 15 years (AU, 2019c: 4)

The lists of excluded, sensitive and non-sensitive products is to determined country by country, except for the East African Community (EAC), the Economic Community of Central African States (ECCAS), the Economic Community of West African States (ECOWAS) and the Southern African Customs Union (SACU), for which common lists for all member States within each of the four regional groupings are established (UNECA, 2019). Moreover, only those countries which have ratified the AfCFTA (or have subsequently acceded) will be bound by the new rules and will enjoy the benefits related to market access in goods and services (TRALAC, 2019).

3. Impact of the AfCFTA on the Kenyan Economy

For this brief, both the Partial Equilibrium (PE) and Computable General Equilibrium (CGE) models are used to analyse the static impact of the AfCFTA on Kenya. PE models give the magnitude of the direct effects of trade policy change without taking into account the sectoral market interactions (feedback effects) whereas the CGE models take into account the second-round effects, such as inter-industry effects and some macroeconomic adjustments. The CGE models, however, rely on a relatively large number of assumptions[12] compared to the PE models which depend on simpler and more transparent assumptions – PE results are largely driven by the data that they are based on and only a relatively limited number of equations are considered in the simulations. More importantly, the data requirements for PE are less demanding than for the CGE, and the PE can provide results at a highly disaggregated level (HS-6 digit product level). Arguably, a combination of both models provides a more comprehensive answer to assessing the impact of trade liberalization (ARIA VIII, 2017). However, the different modelling approaches tend to yield different estimates, largely attributable to the assumptions of the models and variations in the underlying data. Consequently, the derived estimates should only be used to give a sense of the order of magnitude that any change in policy can mean for economic welfare or trade (Piermartini and Teh, 2005).

[12] In CGE models, while other assumptions are theoretically feasible, for reasons of tractability, most models limit themselves to constant economies of scale and perfect competition. For more information on the design and assumptions of the GTAP model, see Hertel (1997). An introduction to CGE modelling using GTAP is to be found in Burfisher (2011).

3.1 Impact Analysis Using the Partial Equilibrium Model

Our partial equilibrium simulations are based on the WITS-SMART model[13], assuming full liberalization of the tariffs on intra-African trade in goods. The model produces estimates of the trade effects and the welfare effect. Data on trade flows and tariffs used in the model are extracted from the COMTRADE and UNCTAD TRAINS database with the underlying data referring to a 2014 base year.[14] The elasticities incorporated in the simulation are for import demand, Armington substitution and infinite export supply (the price-taker assumption).[15]

Significant Gains in the Manufacturing Sector

The results suggest that Eastern Africa as a block[16] could gain around USD 737 million (13 percent) from the increase in the intra-African exports when compared to the exports of the base year (Table 2). In terms of absolute value, Kenya will be the second-largest beneficiary of the AfCFTA in Eastern Africa, with its intra-African exports increasing by around USD 188 million (10 percent). However, these estimated gains actually <u>underestimate</u> the potential impact of the AfCFTA, for four principle reasons:

- **Services trade**
  Has not been considered due to the paucity of both bilateral service trade data and tariffs. Literature has shown that the services sectors are a major beneficiary of deeper regional integration.[17] There are *a priori* reasons to believe that Kenya may be a major beneficiary of the opening up of tradeable services at the continental level. In 2017, Kenya had a trade surplus in service of over USD 1.6 billion compared to the merchandise trade deficit of around USD 11 million, underscoring the importance of the sector (UNCTADStat, 2019). Kenya also has a strong regional footprint in financial services, tourism, the digital economy and ICT. Although the national carrier Kenyan Airways is currently not profitable, there are also major opportunities in the air transport sector and Kenya is among the countries committed to the Single African Air Transport Market (SAATM).

- **New market opportunities**
  Both methodologies used in this document only apply to merchandise trade and are unable to estimate trade which will emerge from new sectors or markets due to the opportunities opened up by the AfCFTA.[18]

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[13] For more details on the model, see Laird and Yeats (1986) and WTO and UN (2011).

[14] The base year for Kenya is 2016 and Rwanda's is 2015.

[15] The 'price-taker' assumption is usually realistic in the case of small countries which export onto global markets, and where their own production costs are unlikely to impact on prices in that particular sector.

[16] Eastern Africa is defined using the UNECA definition, i.e. including Burundi, Comoros, Democratic Republic of Congo, Djibouti, Ethiopia, Eritrea, Kenya, Madagascar, Rwanda, Seychelles, Somalia, South Sudan, Tanzania and Uganda.

[17] Mayer et al. (2018) studied the impact of the European single market over the period from 1950 and 2012 and found that the single market increased services trade by 58 percent.

[18] This is because product categories for which there are initially no bilateral trade flows cannot be projected to become non-zero after the introduction of zero tariffs.

- **Informal sector**
  The estimates are limited to formal sector trade, although informal cross border trade represents a significant portion of the intra-African trade.[19]

- **Existing regional trading arrangements**
  The majority of Kenya's existing intra-African trade is already covered by existing free-trade agreements (Figure 9). As a consequence, the simulations principally capture the benefits arising from new intra-African trading partners with which Kenya does not currently have a functional regional trading arrangement.

Table 2: Change in Intra-African Exports, Post-AfCFTA

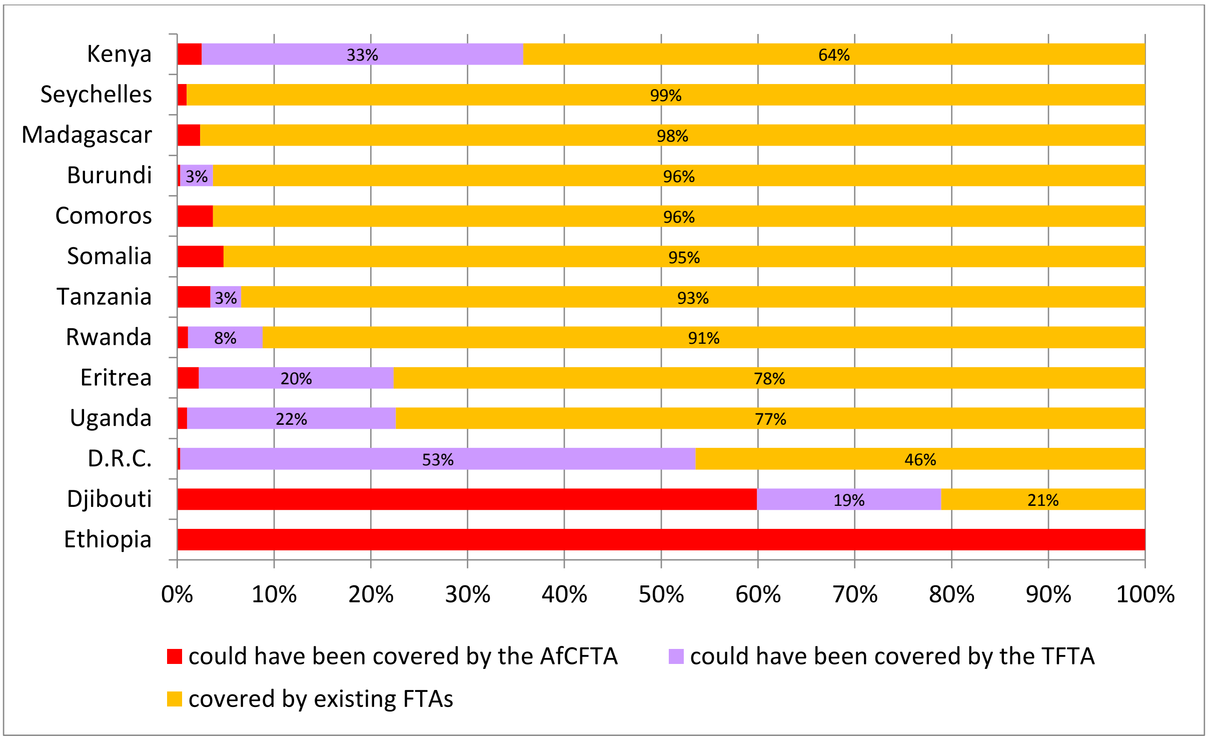
	Absolute amount (USD '000)	Compared to the base year
Eastern Africa	736,501	13%
Kenya	**188,227**	**10%**
Uganda	198,546	21%
Tanzania	171,780	17%
Madagascar	93,186	47%
Rwanda	56,010	22%
Ethiopia	10,718	10%
D.R. Congo	9,843	1%
Seychelles	3,963	7%
Somalia	2,988	31%
Djibouti	716	5%
South Sudan	401	8%
Eritrea	55	1%
Burundi	39	0.4%
Comoros	28	1%

Source: ECA calculations based on WITS/SMART partial equilibrium simulations.

Note: Since the WITS-SMART simulations focus on one importing market and its exporting partners in assessing the impact of a tariff change, the estimates for Uganda, Kenya, and Ethiopia may be underestimated as they do not take into account exports from these countries to South Sudan and Somalia.

[19] There is limited data to show the scale of Kenya's informal cross border trade. Nonetheless, a survey by Uganda Bureau of Statistics indicates that almost a half of Uganda's informal imports originate from Kenya, amounting to an average of USD 28 million over the period 2012-2016 (UNECA, 2019b).

Figure 9: Share of Intra-African Imports Already Benefiting from Free Trade Agreements



Source: ARIA IX (2019)

Kenya's increase in intra-African trade will be most notable in the petroleum and manufacturing sectors. In terms of absolute value, petroleum oils which are largely re-exports register the highest increase in intra-African exports. This points to the ready African market for the country once it starts exporting oil from Turkana. On the other hand, processed leather will experience the biggest boost in percentage terms, reflecting the prevailing low levels of leather intra-African exports from Kenya. This is a major boon to the livestock sector in which the potential for value addition and diversification of leather products are grossly under-utilised, despite Kenya being the third largest holder of livestock in Africa behind Ethiopia and Botswana.[20] The *Kenya Leather Development Council* (KLDC) is developing the country's first *Leather Park* at Kinanie, Machakos County, to increase leather production.[21] Furthermore, the potential increase in export of textile products will stimulate revival of the collapsed domestic cotton industry, improve household incomes and generate employment in rural and urban areas.

[20] In fact, over 89% of leather exports constitute wet blue and crust leather products as opposed to processed products (GoK, 2015).

[21] More information available at: http://kenyaleatherpark.go.ke/about/

Table 3: Change in Kenya's Intra-African Exports by Product, Post-AfCFTA

Product code (HS 6)	Product description	Change in value of exports (USD '000)	% change
271019	Petroleum oils and oils from bituminous minerals, not containing biodiesel, not crude, not waste oils; preparations n.e.c, containing by weight 70% or more of petroleum oils or oils from bituminous minerals; not light oils and preparations	117,797	44%
271012	Petroleum oils and oils from bituminous minerals, not containing biodiesel, not crude, not waste oils; preparations n.e.c, containing by weight 70% or more of petroleum oils or oils from bituminous minerals; light oils and preparations	14,860	11%
530890	Yarn; of vegetable textile fibres n.e.c.	6,410	313%
410792	Leather, further prepared after tanning or crusting, including parchment dressed, of bovine or equine animals, without hair on, other than leather of heading 41.14, not whole hides and skins, but including sides, grain splits	3,460	2,476%
240391	Tobacco; homogenized or reconstituted	2,968	57%
70310	Vegetables, alliaceous; onions and shallots, fresh or chilled	2,627	1,030%
960810	Pens; ballpoint	2,276	18%
491199	Printed matter; n.e.c. in heading no. 4911	1,883	14%
630629	Tents; of textile materials other than synthetic fibres	1,760	167%
410791	Leather, further prepared after tanning or crusting, including parchment dressed, of bovine or equine animals, without hair on, other than leather of heading 41.14, not whole hides and skins, but including sides, full-grain, unsplit	1,597	2,476%

Source: ECA calculations based on WITS/SMART partial equilibrium simulations

Increase in Imports Smaller han Increase in Exports

Since regional integration is always a two-way street[22], imports from other African countries will also increase as a result of the implementation of the AfCFTA. Higher intra-African imports could play a valuable role in terms of accelerating the emergence of intra-regional value chains, and hence should be welcomed. The simulation estimates suggest that Kenya's imports from the rest of Africa will increase by USD 68.2 million (Table 5). However, comparing Kenya's change in imports to that in exports shows that for every unit increase in intra-African imports, intra-African exports would increase by a third, contributing modestly to an improved Kenyan trade balance. At variance with the country's change in intra-African exports by product, vehicle imports will register the highest increase (in absolute amount) in Kenya's intra-African imports (Table 6).

[22] '*Integration is a two-way street. Protectionism is not going to serve anyone well because the moment you start practicing it, you invite others to do the same. It is not healthy globally or when it comes to smaller regional entities.*' President Paul Kagame, CNBC Africa, August 2018

Table 5: Change in Intra-African Imports, Post-AfCFTA

	Absolute amount (USD '000)	Compared to the base year
Eastern Africa	1,490,406	16%
Kenya	**68,159**	**5%**
D.R. Congo	1,079,372	32%
Ethiopia	166,680	21%
Madagascar	77,119	25%
Uganda	31,318	3%
Djibouti	18,144	35%
Rwanda	16,361	2%
Tanzania	14,053	1%
Eritrea	8,947	6%
Comoros	4,302	8%
Seychelles	3,065	3%
Burundi	2,885	2%

Source: ECA calculations based on WITS/SMART partial equilibrium simulations

Table 6: Change in Kenya's Intra-African Imports by Product, Post-AfCFTA

Product code (HS)	Product description	Change in value of imports (USD '000)	% change
870421	Motor vehicles for the transport of goods (excl. of 8704.10), with C-I internal combustion piston engine (diesel/semi-diesel), g.v.w. not >5tonnes	6,333	20%
870332	Vehicles principally designed for the transport of persons (excl. of 87.02 & 8703.10-8703.24), with C-I internal combustion piston engine (diesel/semi-diesel), of a cylinder capacity >1500cc but not >2500cc	3,274	53%
854370	Other machines & apparatus for electrical machines & apparatus, other than machines & apparatus for electroplating/ electrolysis/electrophoresis/signal generators/particle accelerators.	2,107	171%
441011	Particleboard of wood, whether/not agglomerated with resins/other organic binding substances	1,992	78%
80810	Apples, fresh	1,668	15%
220710	Undenatured ethyl alcohol of an alcoholic strength by volume of 80 % vol or higher	1,258	25%
220421	Other wine; grape must with fermentation prevented or arrested by the addition of alcohol: -- In containers holding 2 l or less	1,174	18%
220429	Other wine; grape must with fermentation prevented or arrested by the addition of alcohol: -- Other	1,043	30%
760720	Foil, aluminum, backed, not exceeding 0.2mm thick	830	29%

Product code (HS)	Product description	Change in value of imports (USD '000)	% change
870323	Vehicles (excl. of 87.02 & 8703.10) principally designed for the transport of persons, with spark-ignition internal combustion reciprocating piston engine, of a cylinder capacity >1500cc but not >3000cc	768	27%

Source: ECA calculations based on WITS/SMART partial equilibrium simulations

The AfCFTA Will Lead to Trade Creation

Trade creation within any regional bloc reflects the displacement, due to the tariff reduction, of inefficient (high cost) producers with more efficient suppliers of the same goods within the newly formed continental market, while trade diversion refers to the displacement of the relatively efficient (low cost) producers outside the regional bloc by the inefficient ones within the bloc. The net balance between these two effects is an empirical question - some regional integration projects have been found to be net trade creating. For instance, Robson (1994) avers that larger regional arrangements the more likely to be trade creating, because their members' production structures are most likely to have larger overlaps in their range of products and producers, thus creating a competitive environment. The simulation results suggest that the net impact of the AfCFTA in Kenya will be trade creating and not diverting (Table 6).

Table 6: Trade Creation and Diversion (USD millions)

	Trade Creation	Trade Diversion
Eastern Africa	1,253	219
Kenya	**40**	**28**
D.R. Congo	986	93
Ethiopia	114	53
Madagascar	57	20
Uganda	19	13
Djibouti	14	4
Tanzania	11	3
Rwanda	7	4
Burundi	2	1
Eritrea	2	0.5
Comoros	1	0.5
Seychelles	0.33	1

Source: ECA calculations based on WITS/SMART partial equilibrium simulations

3.2 Impact Analysis Using the General Equilibrium Model

For the purpose of comparison, further simulations were carried out using the Global Trade Analysis Project (GTAP) model. This computable general equilibrium model describes global bilateral trade patterns, production, consumption, and intermediate use of commodities and services, with the underlying data referring to a 2014 baseline. The model is run using a regional aggregation which includes the standard regions included within the GTAP model, with disaggregation of the individual countries/region in Africa. The sectoral aggregation covers 65 sectors. We assessed the impact of implementing the AfCFTA on Eastern Africa and Kenya by simulating the removal of the existing tariffs on all intra-African trade (100 percent liberalisation).[23]

Exports to Ethiopia Will Increase Significantly

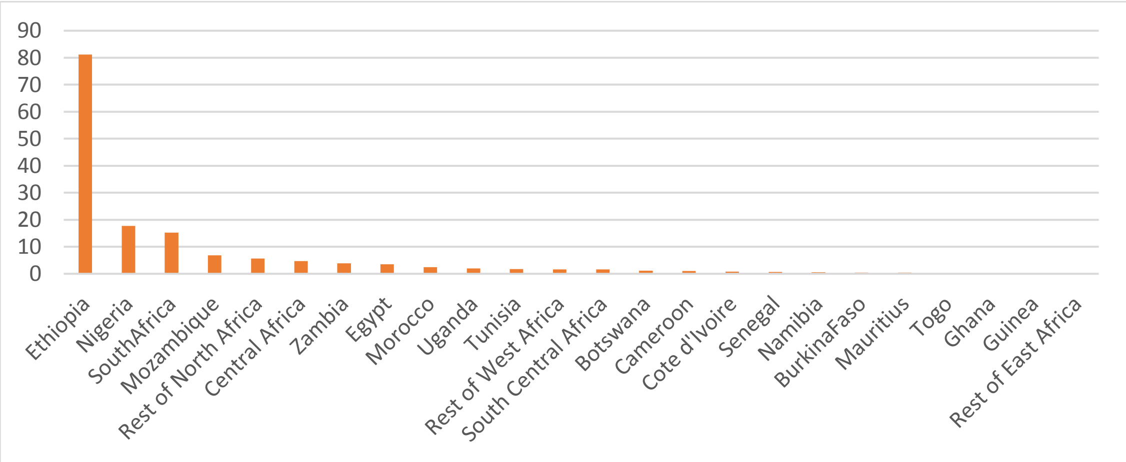
The simulation estimates suggest that the AfCFTA could boost Kenya's intra-African exports by USD 140 million (7%) (Table 7). Approximately 58 percent of these exports will be destined to Ethiopia, reflecting the large market size, proximity, and current high tariff rates. Nigeria is the destination of 19 percent of the additional exports, followed by South Africa at 14 percent (Figure 10).

Table 7: Change in Intra-African Exports for Select Eastern Africa Countries, Post-AfCFTA

	Absolute amount (USD millions)	Compared to the base year
Kenya	140	7%
Tanzania	323	23%
Uganda	141	14%
Ethiopia	113	10%
Rwanda	37	17%

Source: ECA calculations based on GTAP 10.0 database

Figure 10: Geographical Distribution of Additional Intra-African Exports (USD millions),Post-AfCFTA

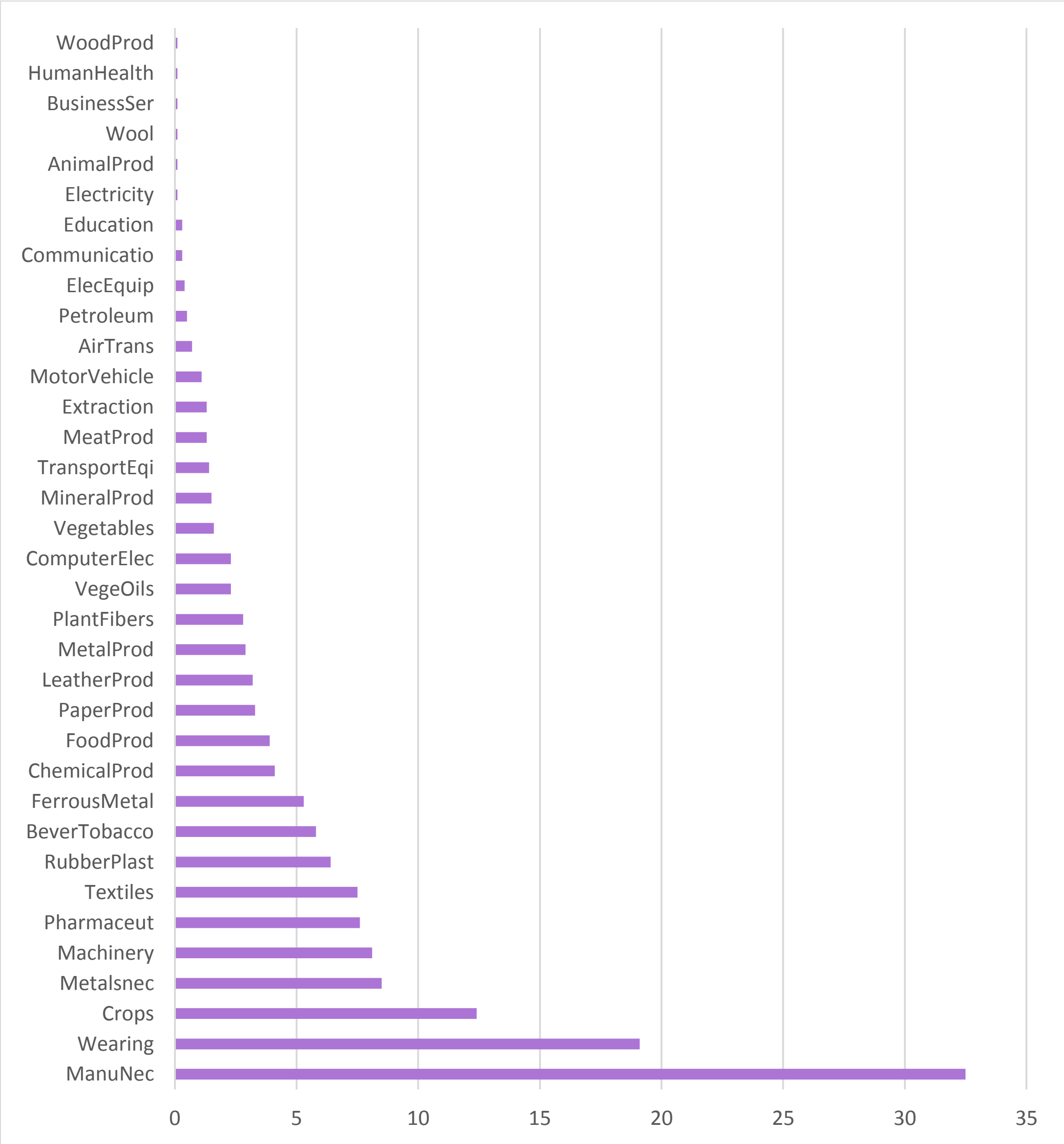


Source: ECA calculations based on GTAP 10.0 database

[23] When the exact results of tariff negotiations are not known, it is common to use full liberalization scenarios in this type of modelling work. The only alternative would be a highly speculative exercise regarding the goods that may be excluded.

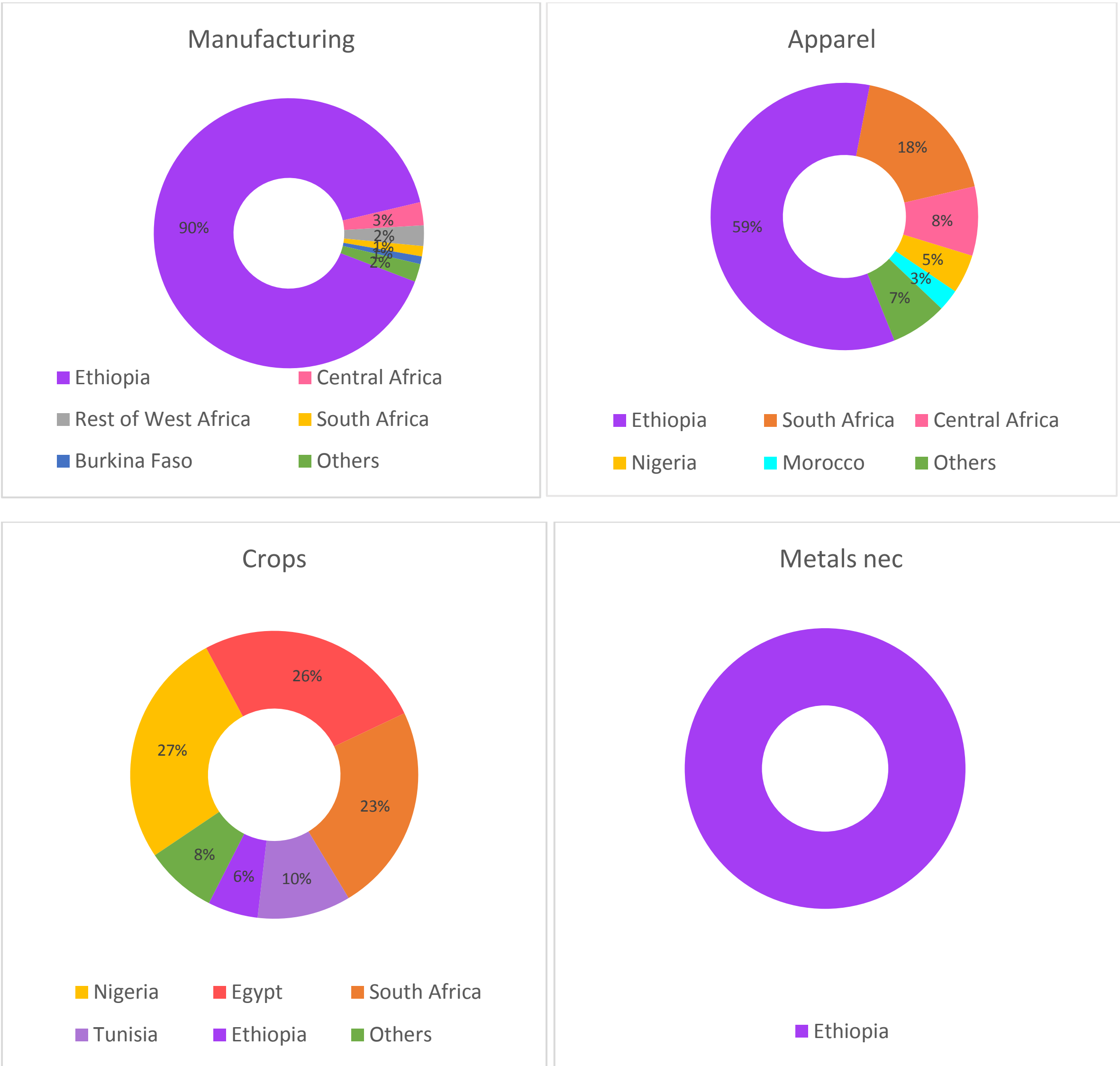
The exports of manufactures, apparel, crops, and metals will register the highest gains, increasing by USD 33 million, USD 19 million, USD 12 million and USD 8.5 million respectively (Figure 11). Further disaggregation of the data reveals that Ethiopia is the sole destination for the additional metal exports. It also accounts for 90 percent and 58 percent of the increase in manufactures exports and apparel exports. The destination markets for the additional crop exports are slightly diversified, with Nigeria, Egypt and South Africa taking up around 75 percent of the exports (Figure 12).

Figure 11: Change in Kenya's Intra-Africa Exports by Product (USD millions), Post-AfCFTA



Source: ECA calculations based on GTAP 10.0 database

Figure 12: Change in Kenya's Top Intra-Africa Exports by Country (%), Post-AfCFTA



Source: ECA calculations based on GTAP 10.0 database. Note: nec refers to miscellaneous products

Imports from South Africa Will Increase Significantly

The simulation estimates indicate that the AfCFTA will increase Kenya's intra-African imports by USD 422 million (Table 8). These imports will be chiefly from South Africa (Table 9). Until either the AfCFTA or the *Tripartite Free Trade Agreement* [24](TFTA) is implemented, Kenya does not currently have any preferential trading arrangement with South Africa.

[24] The TFTA, which is an agreement between SADC, EAC and COMESA, could be considered an important building block for the AfCFTA. Its rapid ratification and implementation would significantly accelerate the coming into force of the AfCFTA in Eastern and Southern Africa. Using a CGE simulation, Mold and Mukwaya (2016) find that TFTA implementation could boost intra-regional trade by 29 percent, and the bulk of that trade would be in the manufacturing sectors, given a decided spurt to industrialisation.

Table 8: Change in Intra-African Imports, Post-AfCFTA

	Absolute amount (USD millions)	Compared to the base year
Kenya	422	16%
Tanzania	663	41%
Ethiopia	515	68%
Uganda	114	11%
Rwanda	57	10%

Source: ECA calculations based on GTAP 10.0 database

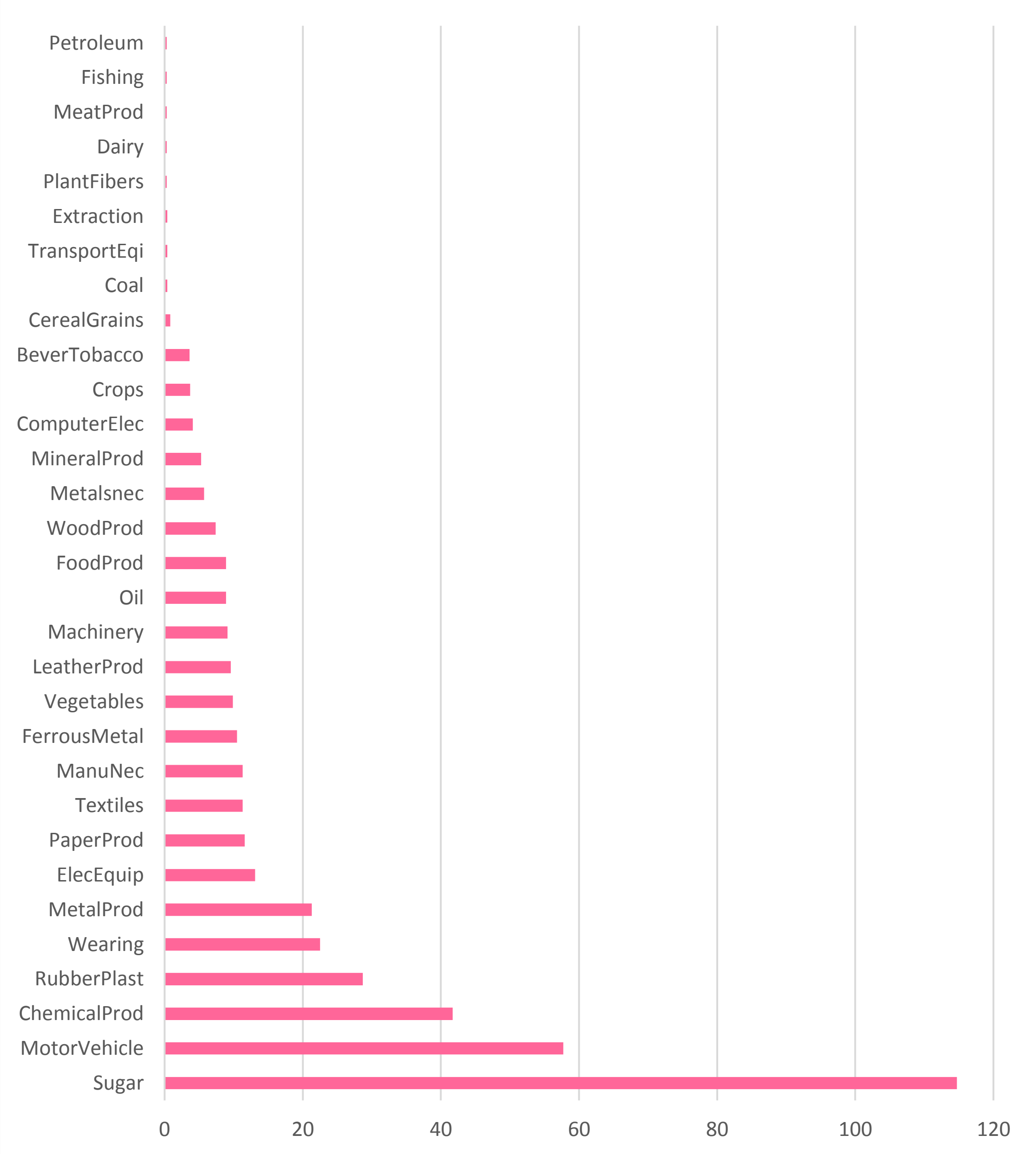
Table 9: Geographical Distribution of Kenya's Increase in Intra-African Imports, Post-AfCFTA

	Absolute amount (USD millions)
South Africa	434.1
Mozambique	14.9
Rest of North Africa	9.2
Morocco	4.9
Nigeria	2.7
Ethiopia	2.2
Senegal	1.2
Cameroon	0.6
Cote d'Ivoire	0.5
Central Africa	0.4
Tunisia	0.3
Burkina Faso	0.2
South-Central Africa	0.2
Botswana	0.2
Togo	0.1
Rest of West Africa	0.1

Source: ECA calculations based on GTAP 10.0 database

With regards to Kenya's intra-African imports by product, the imports of sugar would register the highest increase (Figure 13). This is principally because sugar is a 'protected' product (it's on the sensitive items list) under the EAC and thus attracts the 100 percent duty under the common external tariff (CET). Depending on the outcomes of the negotiations, it is quite possible that sugar retains its status as a 'sensitive' item under the AfCFTA. Additional analysis indicates that South Africa is the sole exporter of these top products.

Figure 13: Change in Kenya's Intra-Africa Imports by Product (USD millions), Post-AfCFTA



Source: ECA calculations based on the GTAP 10.0 database

The AfCFTA Will Result in Large Welfare Gains

Tariff reduction under the AfCFTA will lead to welfare gains in the form of consumer surpluses, producer surpluses and efficiency gains that derive from improved access to imported products, as well as better specialization and economies of scale. Our simulation results estimate that the AfCFTA will lead to net welfare gains of USD 129 million in Kenya. The decomposition of welfare gains shows that overall the endowment effects – which represent changes in the factors of production –constitute the largest share of welfare gains (Table 9)

Table 9: Welfare (Equivalent Variation) effect of the AfCFTA (USD Millions)

	Allocative Efficiency	Endowment Effect	Terms of Trade Effect	Investment Savings	Total
Kenya	**-7**	**192**	**-28**	**-28**	**129**
Ethiopia	60	272	-10	-17	306
Madagascar	1	6	-0.3	0	7
Rwanda	19	52	2	0.7	74
Tanzania	251	623	11	-4	880
Uganda	15	257	8	-0.1	280
Rest of Eastern Africa	33	132	-11	6	159
Total	372	1,534	-30	-43	1,835

Source: Calculations based on GTAP 10.0 database

The Revenue Effect is Likely to be Minimal

The elimination of tariffs under the AfCFTA would reduce tariff revenue, although our estimates suggest that the losses would be modest, given the low level of intra-regional trade and the fact that Kenya has been diversifying the sources of tax revenue. In fact, the country's customs and import duties have declined over the years (Figure 14). Customs and import duties now account for just 9 percent of total revenues compared to 48 percent from income taxes, 27 percent from VAT, and 15 percent (excise duties) (KNBS, 2019).

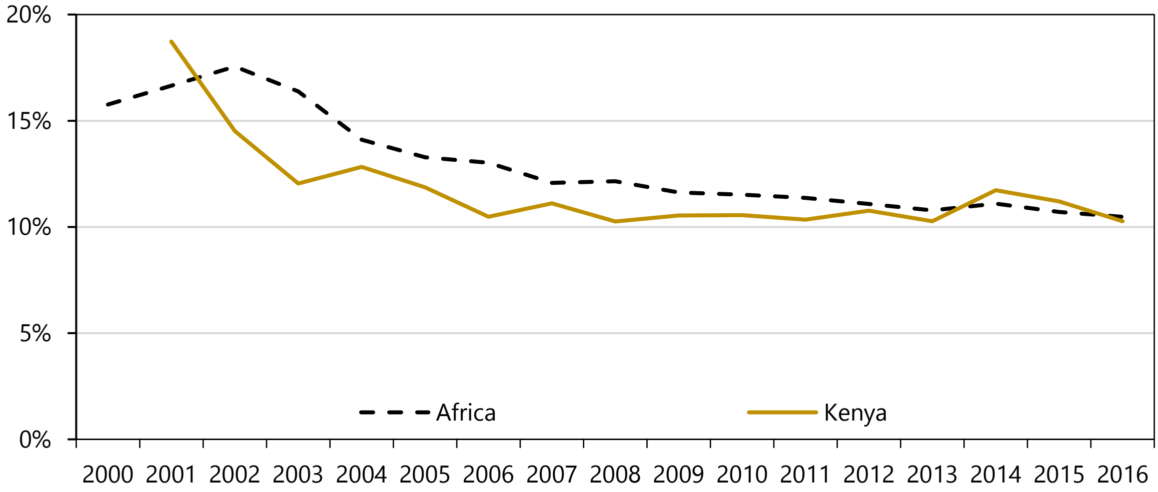
Kenya's revenue losses are a paltry 0.6 percent of total government revenues (Table 10). Moreover, the tariff revenue losses in the short-run should not be understood as absolute losses but as redistribution of income from the government to consumers and producers (i.e., lower taxes paid by domestic consumers and exporters). The loss of revenues may also be construed as a small price to pay for the wider economic benefits accruing from the implementation of the AfCFTA, and indeed it is not unrealistic to project in the medium- to long-term increased tax and revenue income from the higher levels of economic activity due to the AfCFTA.

Table 10: Summary Results of Tariff Revenue Losses

	Tariff revenue loss (US$ million)	As a share of total tariff revenue	As a share of total government revenue
Kenya	**67**	**3%**	**0.6%**
Uganda	23	8%	0.6%
Ethiopia	61	6%	0.7%
Madagascar	2	0.7%	0.1%
Rwanda	6	4%	0.3%
Tanzania	91	6%	1.3%

Source: Calculations based on the GTAP 10.0 database.

Figure 14: The declining share of customs and import duties as a percentage of total tax revenue



Source: OECD Stat (2019).

4. Conclusions

This brief analyses the effects of the AfCFTA on Kenya using both the partial equilibrium and the CGE models. While the results of the two models may have been different in terms of the magnitudes of effects (because of the different assumptions and sources of data considered), both models were consistent in terms of the direction of the effects. The results suggest that tariff liberalization under **AfCFTA will boost Kenya's intra-African exports by between USD 140 and 180 million**, with manufacturing being among the main beneficiary sectors. This is a sector that will provide more decent jobs with higher productivity and wages and promote structural transformation, in line with the industrialization objectives outlined in *Vision 2030*, the *Kenya Industrial Transformation Program* and most recently, the *Big Four Agenda.*

Nonetheless, there are a range of **potential benefits of the AfCFTA that our simulation estimates do not reveal**: (i) The gains from services trade liberalization, for which there is strong *a priori* evidence of large impacts. Kenya has a services trade surplus of over USD 1.6 billion compared to the merchandise trade deficit of around USD 11 million, underscoring the importance of the sector (UNCTADStat, 2019). (ii) Impact of greater intra-African FDI as there is evidence this creates more employment opportunities than extra-African FDI (Gold et. Al, 2017).[25] Moreover, increased intra-regional FDI would greatly increase the chance of the emergence of intra-regional value-chains and contribute very positively to the diversification of both composition and markets of FDI flows (iii) The benefits that will accrue from the emergence of new activities or trade as both models are incapable of predicting the emergence of new sectors or trade in products where there was none previously (UNECA, 2019a). (iv) The benefits associated with the protocol on free movement of persons, rights of residence and rights of establishment.[26]

Kenya needs to take advantage of the series of initiatives have been unveiled in support of the execution of the AfCFTA:

- **The AfCFTA Adjustment Facility**, a USD 1 billion financing facility by the African Export-Import Bank (Afrexim Bank). The funds will serve as a support to participating countries with initial fiscal imbalances arising from the execution and firm up arrangements to improve their capacity.

- **An online mechanism tool for non-tariff barriers (NTB) reporting, monitoring and elimination** available at https://tradebarriers.africa/home which is a joint project by UNCTAD and AUC namely *AfCFTA support programme to eliminate non-tariff barriers, increase regulatory transparency and promote industrial diversification*.

- The **Africa50 Pan-African Investment Platform**, as part of the Programme for Infrastructure Development in Africa (PIDA). Though the country has ongoing infrastructure projects such as the standard gauge railway and the Lamu Port South Sudan Ethiopia Transport (LAPSETT)

[25] In a data set using firm level data for 19 Sub-Saharan countries (7 of which are from Eastern Africa - Burundi, Ethiopia, Kenya, Madagascar, Rwanda, Tanzania and Uganda), Gold et. al. (2017) find that not only is employment growth generally higher for firms receiving FDI from other African investors compared with Northern investors, but that they also receive more technology transfer from their parent company abroad.

[26] Data from the World Bank Enterprise Surveys (World Bank, 2019b) shows that while Kenya suffers less than the Sub-Saharan average from skills shortages (approximately 1 in 10 firms report an inadequately trained workforce as a major constraint, compared with 1 in 5 for SSA), Kenya could still benefit from highly skilled workers from other parts of the continent, while its graduates would also be in a strong position to use their talents in other countries in the region.

Corridor Programme, it is crucial that Kenya connects not only with its neighbours but also the rest of the continent.

However, without broad public support for the AfCFTA, it will impossible to create a unified continental market. For the agreement to be implemented and benefits to materialize, both the general public and private sector should be fully aware of the implications of the AFCTA. This requires a campaign-type approach to raising popular awareness on the benefits arising from the AfCFTA.

Finally, the Kenyan government authorities must work closely with the East African Community in adopting a common position with regard to all areas of negotiation of the AfCFTA. It is essential that all six Partner States of the EAC take a common position on these matters – there is no option of a 'variable geometry' with respect to the AfCFTA without undermining the viability of the Customs Union.

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