THE BUSINESS ADVOCACY FUND
Supporting Private Public Dialogue

Promoting tariff free access for horticulture to Europe

A cost benefit analysis

May 2017

This is the second in a series of reports intended to offer an assessment of the benefits delivered by selected projects supported by the Business Advocacy Fund compared to the costs incurred by BAF in supporting the project. As we note in our factsheet (available from businessadvocacy.org), cost benefit analysis (CBA) is a technique used to estimate the monetary value of the benefits and the costs to the community to assess whether a proposed initiative is worthwhile. The concept was originally developed by Jules Dupuit, a French engineer, and was further elaborated by a British economist, Alfred Marshall. Much of the practical development, however, came about because of the US Federal Navigation Act of 1936 which required that the US Corps of Engineers carry out projects to improve the waterway system when the total benefits of a project, irrespective of where they accrued, exceeded the costs. Inevitably, there are a large number of assumptions made in preparing a cost benefit analysis and this is particularly true in environments where there is a lack of detailed data. However, we think that it is appropriate to provide these assessments publicly, partly so that interested parties can consider whether the projects offered value for money, but also to provide an opportunity for others to challenge our assumptions and to offer better data on which to base our calculations.

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1. Background

Horticulture is Kenya's third highest contributor of foreign exchange earnings. It contributes roughly 1.5 per cent to GDP. It employs two million people.[1] The EU is the principal importer of Kenya fresh produce. Britain, France, Germany and the Netherlands and are major importers of fruits and vegetables. The Netherlands imports the bulk of flowers. The Middle East is an important market for Kenyan fruits.[2]

Starting in 1973, the EU has allowed African, Caribbean and Pacific countries one way tariff, duty and quota free access to EU markets under the Lome Convention. This meant that ACP producers were able to export to the EU, but remained protected from European competition.

Under (more recent) WTO rules however, and the expiry of Lome and its successor, the Cotonou Partnership Agreement, the EU and ACP were given until the end of 2007 by WTO to implement WTO compliant arrangements. These are known as Economic Partnership Agreements (EPAs). EPAs are designed to be reciprocal agreements aimed at contributing to sustainable development and the reduction of poverty in the ACP regions.

The Fresh Produce Exporters' Association of Kenya (FPEAK) was understandably worried about both the content of the interim EPA, and the main EPA, and indeed whether they would be signed by the Government of Kenya. BAF supported FPEAK which lobbied around East Africa, the Government of Kenya and the European Commission in its efforts to ensure that the interim was both satisfactory and signed.

An Interim Agreement (which would become part of the main EPA) was signed in late 2007 (i.e. within the agreed deadline) by the EU, the East African Community (EAC), the remaining ESA members on the African continent (as a bloc) and those other ESA countries that are off-shore from the African continent (again as a bloc). The timing of the signing meant that horticulture trade flows from Kenya to the EU were not interrupted.

The interim EPA was due to expire at the end of Sep 2014, which might have been expected to offer enough time to conclude negotiations on the full EPA. However,

[1] For more detail, see softkenya.com/Kenya/horticulture-in-kenya

[2] End of project evaluation, 2009

the EU was keen to conclude by the end of 2013.And each side kept introducing new issues, including in the areas of export taxes, most favoured nation status, restricted cumulation with South Africa on selected produce, marine fisheries and rules of origin. So BAF supported a consortium of FPEAK with the Kenya Association of Manufacturers (KAM), the Kenya Flower Council and the Association of Fish Processors & Exporters of Kenya (AFIPEK) to lobby on those issues and others. In the end, agreement was reached but with a slight delay such that the interim EPA lapsed and Kenyan exports to the EU were subjected to payment of Generalised System of Preferences (GSP) duties of between 4.5 and 8.5 per cent for the period of 1 October to 25 December 2014.

The full EPA was agreed though so far has been ratified only by the Governments of Kenya and Rwanda. Tanzania has so far refused to sign, and indeed there is widespread hostility amongst the private sector in Tanzania to the EPA. Uganda is refusing to sign unless there is unanimous EAC support. For the time being, the EU is allowing Kenya to continue to export as though the EAC had signed the EPA.

Without agreement, it is likely that Kenyan horticultural exporters will be forced to adjust their prices to reflect GSP tariffs though flowers are now outside the GSP. FPEAK claims, not unreasonably, that this will make Kenyan horticulture uncompetitive. Indeed, it would be likely to lead to disinvestment in the Kenyan industry and migration to lower cost environments, such as Ethiopia. Kenya could potentially sign individually, but it would have to do so as a middle-income country, resulting in a less favourable arrangement.

This note has been prepared on the basis that the status quo, a signed EPA, will remain in place for the foreseeable future.

2. THE EVIDENCE

There are a number of ways in which we can attempt to estimate the impact that would have occurred had the Government of Kenya failed to sign the interim EPA and then the full EPA.

The fear, before the interim EPA was signed, was that Kenya might have had to negotiate individually with the EU under the General System of Preferences (GSP). At that time, the average GSP tariff was 8 per cent. The imposition of such a tariff could have led to significant restructuring of the industry – in other words, job losses – in order to remain competitive or, worse, that enterprises would simply move to 'least developed countries' such as Sudan or Ethiopia to continue to access Europe tariff free. It is also possible that European consumers would have accepted at least some of the rise in prices. As a proxy, we could assume that Kenyan farmers would have to absorb most of the tariff and assume a reduction in incomes of around 6 per cent per annum. This calculation would not cover the social dislocation costs of the probable unemployment. Nor would it cover the alternative investment that would be required to replace the employment and foreign exchange earnings lost (with a likely impact on the value of the Kenya Shilling exchange rate in the interim).

The gap in the timing between the expiry of the interim EPA and the signing of the full EPA however does provide us with some additional evidence on the scale of the potential problem.

Kenya National Bureau of Statistics records exports by value and records horticulture exports as a percentage of total exports and we have statistics available up to 2016. However, it is especially difficult to get a handle on the economic performance of horticulture. Sales by volume can rise at the same time that sales by value is falling and vice versa. Furthermore, there are very many factors that impact on sales including world prices, exchange rates, regulation (for example recently the EU became worried about excessive pesticide residue leading to greater levels of inspection), lower yields and lack of agricultural finance, all of which makes it very difficult to isolate the impact of any particular policy. It is worth noting too that not all authorities agree on the figures. NaHMIS, for example, reports sales by value of KES72bn in 2009 and KES77bn in 2010. For consistency, therefore, we have used KNBS figures which we have for all years.

It is difficult to find predictions of growth rates but one source is predicting 6% in 2016 and 2017 so we have used that for each year until 2020. It is more difficult to get accurate figures of sales to the EU, but the Nation (26 Jan 2015) helpfully quoted a percentage for 2014 and we have used that for other years as well. Others argue that the percentage of exports is higher.

The greatest challenge is to estimate the level of sales that would be lost if the EU imposed tariffs. Helpfully, the KNBS Economic Survey 2015 (p158) offers some insight here, explaining that when the interim EPA expired in the second half of 2014, the EU did impose tariffs. Exports of cut flowers and fruit both rose, but sales of vegetables by volume declined by 10 per cent. Indeed, KNBS claims that delays in signing the EPA affected export performance during the period. FPEAK explains that exporters, knowing that the EPA was about to be signed, did their best to continue to honour contracts at the agreed prices. A report prepared for KAM and the other private sector EPA task force institutions in Sep 2016 estimates that Kenya could lose as much as 60 per cent of its exports to the EU if there is a move to GSP.

So, we have made conservative assumptions that (a) 72 per cent of Kenya’s horticulture exports go to the EU and (b) the overall fall in sales by value would have equated to a 10 per cent fall in value. Ee have further assumed that (c) the exporters would not have been able to find alternative markets, not least because Kenya is over-reliant on exporting to Europe whereas its competitors are more diversified and thus Kenya would struggle to open new markets, at least in the short term.

Figure 1: Summary of economic analysis

			2015	2016	2017	2018	2019	2020
			-2	-1	0	1	2	3
Value of total exports (1)		KES'bn	500					
Horticulture exports as %age of total exports (1)			0.202					
Value of horticulture exports, with annual increase by value from 2016 of	6%	KES'bn	101	107	113	120	128	135
Exports which go to EU (2)	72%	KES'bn	73	77	82	86	92	97
Reduction in sales caused by imposition of EU tariff	10%	KES'bn	7	8	8	9	9	10
Reduction in sales caused by imposition of EU tariff	0.103	$'m	70	75	79	84	89	94
Net present value			73	76	79	76	72	69
Total Benefit								372
Attribution	Medium	50%						186

There are then two further challenges in determining the total benefits: over what period should we count them and what is the level of attribution.

Often, a cost benefit analysis looks ahead five years or thereabouts. In this case, we have looked ahead six years, which will mark the end of the third BAF programme.

It is necessary to ensure that benefits and costs are brought back to current values, so we have used net present values for future years, with a discount factor of 11, which represents the approximate borrowing rate. For consistency, we should use the same approach for prior years, in this case compounding. However, instead of using the cost of borrowing, we have used a rate much closer to the level of interest that might be earned on a deposit and used a factor of two (A lower discount factor and a higher compound factor would increase the net benefits, and we are erring on the cautious side).

Often it is difficult to make an assessment of attribution. In the case of the interim EPA, FPEAK was extremely active in lobbying the Government of Kenya and others. For the full EPA, FPEAK and the Kenya Association of Manufacturers, another business membership organisation, worked in alliance. There is little doubt that in both cases they succeeded in influencing the wording of the EPA. However, the Government itself was keen to sign an EPA as was the EU, so there was considerable momentum. On the other hand, the horticulture exporters had the most to lose from failing to agree and sign the EPA so FPEAK was assiduous in its efforts. We have therefore assessed attribution as medium and suggest that at most FPEAK and KAM ad their coalition partners are only 50 per cent responsible for the outcome.

This gives a total benefit of $186m.

3. Costs

BAF supported FPEAK in 2007/8 to take the lead on lobbing in relation to the interim EPA and then supported KAM to take the lead on lobbying in relation to the final EPA in 2013-2016. The total cost of the two interventions was about KES14m or about $155,000 at the prevailing exchange rate. However, this rather understates the total cost since FPEAK and KAM participated in training programmes and were given advice, guidance and support by the BAF team. The total budget for BAF for the first two phases was $11m. The grant given was around 3 per cent of the total given as grants for advocacy, so a fair proportion of the total cost would be $330,000.

The EAC-EU EPA was ratified by Kenya's parliament in Sep 2016. There continues to be concern, however, that other countries of the EAC will not sign the agreement and so BAF is continuing to support KAM at a further cost of almost KES17m or about $170,000 at the current exchange rate. We cannot uprate this because we do not know how much will be spent altogether in the different components, but have assumed that the total will again be equivalent to 3 per cent of the total budget giving an uprated amount of $200,000. That gives a total expected cost for this project of $530,000.

4. Conclusion

The assumption is that the agreement reached in the EPA will prevail for Kenya and, at least for the time being, goods are being exported to the EU in accordance with the agreement. That means that the ratio of benefits to costs is around 350. The horticultural sub sector has consistently been the fastest growing industry within the agricultural sector in Kenya, recording average annual growth of 15-20 per cent. It contributes positively to wealth creation, poverty alleviation and gender equity especially in the rural areas. It employs approximately two million people countrywide directly in production, processing and marketing, of whom around 80 per cent are small scale businesses, and supports as many as a further 3m people indirectly. So this project scores highly on return on BAF's investment, sustained foreign exchange earnings and sustained employment.