

**Export Processing Zones in  
Sub-Saharan Africa – Kenya and Lesotho**



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## Abstract

This thesis examines two cases of Export Processing Zone (EPZ) programmes in sub-Saharan Africa (SSA), specifically in Kenya and Lesotho. Using data from the respective countries' EPZ programme authorities, central banks, relevant studies, and country reports, I show that although the programmes have facilitated employment generation and foreign exchange earnings from textile and apparel exports, such exports rely highly on preferential trade agreements such as the African Growth and Opportunity Act (AGOA). The reliance on preferential market access, and the uncertainty regarding the continuation of such preferences are important sources of vulnerability. This causes fluctuations in investments and also helps explain the low level of backward linkages. This is especially evident in Lesotho. Moreover, such production within the zones is mainly of low productivity and low added value. The vast number of zone programmes that have materialised in the last decades has contributed to reducing the possible net benefit of EPZs, and the increase in competition has made it difficult to attract investors. Zone programmes in Kenya and Lesotho are seen as relatively successful compared to other SSA zone programmes, yet investment and employment levels within the zones are low compared to many programmes in other regions. Several factors hamper larger investments, such as high labour unit costs, high electricity prices, inefficient bureaucracy, corruption, as well as labour unions and political opposition. EPZ programmes may help make it easier to do business in the host countries, and improve investors' perception of the countries' attitudes towards foreign direct investment (FDI). However, SSA zone programmes should to a greater extent target industries and services in which they have good prospects of developing a competitive advantage, regardless of trade preferences, which provide good opportunities for human capital and technology transfers, and which generate demand linkages. SSA countries with large endowments of natural resources may be better able to capitalize upon their comparative advantage by focusing on industries that take advantage of the countries' natural resources, rather than on the labour-intensive industries that have traditionally located in EPZs. Due to high competition and demand for good quality infrastructure, EPZ programmes are generally better suited in more developed SSA countries than as a tool to facilitate development in the poorest countries.

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## List of Acronyms

AEO	African Economic Outlook
AGOA	African Growth and Opportunity Act
ACTIF	African Cotton and Textile Industries Federation
CBL	Central Bank of Lesotho
CBK	Central Bank of Kenya
COMESA	Common Market for Eastern and Southern Africa
EAC	East African Community
EC	European Commission
EPZ	Export Processing Zones
EPU	Export Processing Units
EBA	Everything but Arms
FDI	Foreign Direct Investment
FTZ	Free Trade Zones
GCI	Global Competiveness Index
GDP	Gross Domestic Product
GSP	Generalised System of Preferences
ICT	Information and Communication Technology
IDZ	Industrial Development Zones
IFC	International Finance Corporation
ILO	International Labour Office
KenInvest	Kenya Investment Authority
KEPZA	Kenya Export Processing Zones Authority
KNBS	Kenyan National Bureau of Statistics
KOL	Kingdom of Lesotho
KSh	Kenyan Shilling
LaRRI	Labour Resource and Research Institute (Namibia)
LHWP	Lesotho Highlands Water Project
LNDC	Lesotho National Development Corporation
LTEA	Lesotho's Textile Exporters Association
MFA	The Multi Fiber Arrangement
MNC	Multinational Corporations
MTICM	Ministry of Trade and Industry, Cooperatives and Marketing (Lesotho)
NITA	National Industrial Training Authority
SACU	Southern African Customs Union
SADC	Southern African Development Community
SEZ	Special Economic Zones
UNIDO	United Nations Industrial Development Organisation
UNCTAD	United Nations Conference and Trade and Development
USTR	Office of the United States Trade Representative
USITC	United States International Trade Commission
WEF	The World Economic Forum

# Chapter 1

## Introduction and Economic Theory

### 1.1 Introduction

The last decade has seen significant economic growth in a number of African countries, with sub-Saharan Africa (SSA) one of the fastest-growing developing regions in 2011. Most SSA economies have struggled to generate structural transformations of their economies, changing their export structure from a heavy reliance on natural resources and increasing higher-value production. SSA also needs to generate large-scale employment, especially to absorb the expected growth in the labour force (United Conference on Trade and Development (UNCTAD), 2012a). This thesis attempts to understand the relevance of Export Processing Zones (EPZs) and Special Economic Zones (SEZs) in creating a more diverse economy and generating employment. This first chapter introduces relevant background for the topic and discusses the resource question and methodology in more detail.

It is recognised that the manufacturing sector historically has been the most important engine of sustained and rapid growth in a number of countries. Manufacturing in SSA generally contributes to only a small share of gross domestic product (GDP), and SSA's share of global light manufacturing has been declining rather than increasing.<sup>1</sup> Africa as a whole has experienced a decline in manufacturing as a share of total GDP from 15% in 1990 to 10% in 2008 (UNCTAD, 2012a; Dihn et al., 2012).<sup>2</sup> High export growth, especially of manufactured goods, has historically been closely correlated with high economic growth in developing countries.<sup>3</sup> Higher export earnings improve a country's ability to import capital goods necessary for investments and to purchase intermediate goods required for production (Cline, 1984). Labour-intensive manufacturing has in previous decades furthermore contributed to structural transformation in a number of regions and countries with economic

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<sup>1</sup> Today the share is less than 1%, despite a number of duty-free and quota-free agreements giving access to markets in the US and Europe (Dihn et al., 2012).

<sup>2</sup> Southern Africa experienced a fall from 23% to 18%, Eastern Africa from 13% to 10%, and Central Africa from 11% to 6%. West Africa experienced the largest decline from 13% to 5% (UNCTAD, 2012a, p. 3).

<sup>3</sup> See, e.g., Todaro and Smith (2009). Cline (1984) argues that analysis shows that growth in exports has a stimulating effect on GDP, even if one controls for the fact that exports are included in GDP. Chow (1987) furthermore finds strong causality between export growth and industrial development.



success, such as in East Asia and China, but has yet to take place in SSA countries (UNCTAD, 2012a; Dihn et al., 2012).

The establishment and use of EPZs, SEZs, and *maquiladoras*, as the zones are called in Mexico, is related to remarkable industrial development in some countries. The zones aim to enhance and diversify exports, and generate employment and foreign exchange earnings by attracting foreign capital.<sup>4</sup> Foreign direct investments (FDI) may facilitate further positive externalities, such as technology and knowledge spillovers, that may contribute to improving the host countries' competitiveness and integration in the global economy. The number of zones has increased considerably in recent years from 176 zones in 47 countries in 1986, to a remarkable 3500 zones in 130 countries in 2006.<sup>5</sup> The number of SSA zone programmes has also increased substantially, with most of them established in the 1990s. Several countries have however had earlier comparable policies, e.g., South Africa (Stein, 2012; Jauch et al., 1996). Today, between 20 and 30 African countries use different variations of EPZs to attract investments (Boyenge, 2007; Farole, 2011).<sup>6</sup> The significant growth in the number of zones may have a substantial effect on the net benefit of zone programmes, as elaborated further, later in this thesis. Zone programmes should optimally use the country's comparative advantage, build economies of scale, utilize trade preferences to encourage investments, and facilitate trade. The general conclusion in the literature is that African zones, with a few exceptions, have been unsuccessful relative to many non-African zones. Despite this and the increasing costs associated with the EPZ incentive packages, many African and non-African governments remain committed to zone programmes.

This thesis aims to answer if EPZ programmes can be expected to have a positive long-term effect on economic growth in SSA, by exploring the potential benefits of EPZ programmes and the factors that determine and hamper investments within SSA zones. The first chapter gives an introduction to the economic theory of export-led growth and the use of export zones, and, as noted above, also discusses the research question and methodology. The second chapter reviews the literature regarding empirical findings of the effect of zones as well as the determinants of investments in both non-African and African (with the focus on

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<sup>4</sup> FDI may reduce the gap between domestically available savings and desired investment, with consequent positive effect on economic growth (Todaro & Smith, 2009).

<sup>5</sup> The different definitions of the zones and difficulties in attaining reliable data bring about some differences in the exact numbers of zones and employees reported in the literature.

<sup>6</sup> ILO data includes Cape Verde, Cameroon, Cote d'Ivoire, Gabon, Ghana, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Namibia, Nigeria, Mauritius, Mozambique, Togo, Senegal, Sudan, South Africa, and Zimbabwe (Boyenge, 2007).

SSA) countries. The literature review also looks at different reasons given for the failure of many SSA zones. Chapters three and four provide case studies of SSA EPZs, specifically Kenya and Lesotho, respectively. The zones' effect on growth, diversity of exports, and employment, and the countries' ability to attract investors are explored. These two countries have been relatively more successful than other zones in SSA, which make them interesting cases to study. They both have had relative success in the apparel sector, which allows a degree of comparison. The two countries do however differ in population size, location, natural resources, and economic significance in their respective regions. The fifth chapter takes the form of a discussion, whose ultimate aim is to address the research question by applying the context provided in the literature review to the case studies. It concludes with an examination of the potential and the limitations of EPZ programmes, and the policy implications they may have.

## 1.2 The Aim and Definition of EPZs

'EPZ' is the most commonly used term among a variety of names and forms of a rather popular trade policy instrument used in the last few decades. Other names used include: 'SEZs', such as those found in China, 'free trade zones' (FTZs), 'industrial development zones' (IDZs, in South Africa), and '*maquiladoras*' (in Mexico). The terms are most often used interchangeably in the literature. This thesis mainly uses 'EPZ' as a common term for the zones. The International Labour Organization (ILO) defines EPZs as "industrial zones with special incentives set up to attract foreign investors, in which imported materials undergo some degree of processing before being (re-)exported again" (2003, p. 1).<sup>7</sup> Baissac (2011, p. 23) defines SEZs as "geographical areas contained within a country's national boundaries where the rules of business are different from those that prevail in the national territory". The zones are intended to be both more liberal and more effective and the different rules include "investment conditions, international trade and customs, taxation and the regulatory environment" (Baissac, 2011, p. 23).

The main objective of EPZs is to attract investments that would otherwise not materialize and, as such, promote nontraditional exports, generate employment, and enhance the host country's foreign exchange earnings. The long-term logic of EPZs is that foreign investments have the ability to create much-needed transfers of skills and technology, fostering local spin-offs, increasing knowledge of how to enter the global market, and

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<sup>7</sup> ILO (2003) includes free-trade zones, SEZs, and *maquiladoras* when talking about EPZs.

improving access to international distribution channels. These potential gains are used to justify the considerable investments needed to establish the zones, and are further explained in the next subsection (Stein, 2012; Wu, 2009).

Firms established within the zones are most often given tax exemptions, called ‘tax holidays’, which are a reduction of corporate income taxes for a period of time (Rolfe et al., 2004). EPZ firms are further commonly allowed unlimited duty-free import of raw and intermediate inputs and capital goods for production, and unrestricted repatriation of profits. Infrastructure, such as transport, electricity, and water, is generally well developed relative to the rest of the country, and subsidised by the government (Kaplinsky, 1993; Mandani, 1999). Service provisioning may also be subsidised, and bureaucracy simplified. Investors are typically given the benefit of dealing with only one office in setting up operations (see e.g. ILO, 1998). Some countries also restrict union activities within the zones and offer EPZ firms greater flexibility regarding working conditions and workers’ rights to make the zones more attractive for investors (Jauch et al., 1996). Poor working conditions and marginal wages are one of the main critiques against the use of zones as a development tool, as is discussed further in the next chapters.

The traditional EPZ model mainly limits activities to light manufacturing, and allows for developing countries to take advantage of their low-cost and low-skilled labour by attracting export-oriented enterprises to the zones (Kaplinsky, 1993). Traditionally the zones have also been kept separated from the domestic economy by geography or jurisdiction. There has however been a gradual shift from the traditional EPZ model to a range of different zones offering a greater variety of incentives and economic activities, such as “agriculture, manufacturing, construction, communication, trade, catering, housing, public utilities, and other services as finance and tourism” (Stein, 2012, p. 325). The zones are often now also less isolated from the domestic economy, and may also produce for the domestic market. Zones are furthermore increasingly developed by the private sector. Some countries do however give EPZ incentives to single firms that mainly produce exports. These firms are called ‘export processing units’ (EPUs), or ‘single factory units’, and are in general not required to locate in a specific area (Stein, 2012; World Bank, 1992).

### **1.3 The Benefits of and Obstacles to Trade and Industrialisation and the Role of EPZs**

The benefits of trade are often explained by the theory of comparative advantage, which states that a country should, and will, specialise in exports in which they have a

comparative advantage relative to other countries, in terms of resource endowments and/or natural abilities. A country has a comparative advantage in producing a good if the opportunity cost of producing it is lower than in other countries (Krugman et al., 2012; Todaro & Smith, 2009).<sup>8</sup> A country's comparative advantage may change over time, due to changes in prices on output, production costs, or the opportunity costs linked to production. This implies that countries can take measures to develop or change their comparative advantage (see, e.g., Wood and Berge, 1997). Developing countries often have abundant and cheap unskilled labour and for this reason have a comparative advantage relative to developed countries in labour-intensive production, such as primary production and low-skilled manufacturing jobs. A fall in prices of primary commodities relative to manufacturing goods, has however caused a continued decline in terms of trade for countries mainly exporting non-oil primary goods. The Prebisch-Singer thesis predicts the decline to persist due to the low income from and price elasticity of demand for primary commodities. Developing countries that for the most part export primary goods will for this reason experience a further disadvantage relative to developed countries, making it difficult for them to 'catch up'. Prices of primary commodities have also historically seen larger fluctuations than prices of manufactures, causing great uncertainty for countries dependent on export earnings from such products. Production of primary products is, moreover, typically a low productivity activity, causing overall productivity in the economy in many developing countries to remain low. Productivity growth is a central factor of economic growth. A transfer of labour and other resources to higher-productivity activities may hence have a substantial effect on economic growth, even if productivity levels within the different sectors do not increase (McMillan & Rodrik, 2011; Todaro & Smith, 2009).<sup>9</sup> <sup>10</sup> For these reasons many see the key to economic growth in industrialisation, and in an increase of higher-productivity activities.

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<sup>8</sup> Comparative advantage in one industry is dependent on both productivity and wages, and wages are dependent on productivity in all sectors (Krugman et al., 2012; Todaro & Smith, 2009).

<sup>9</sup> Overall productivity in the economy will depend both on productivity within the different industries and the allocation of resources. A country may hence achieve productivity growth in the overall economy both by transferring resources to higher-productivity activities, and by raising productivity levels in the different sectors (see, e.g., McMillan & Rodrik, 2011).

<sup>10</sup> The Lewis (two-sector) model is maybe the best-known theory of structural transformation. The model includes two sectors: a traditional subsistence sector, with surplus labour and zero marginal productivity, and a high-productivity, modern, industrial sector. The modern sector will optimally expand and attract labour from the subsistence sector until all surplus labour is engaged in the modern, high-productivity sector, and marginal productivity in the subsistence sector is no longer zero. Due to the surplus rural labour, Lewis assumes the cost of labour in the modern sector to be constant until all surplus labour in the subsistence sector is transferred. The growth of output in the modern sector is determined by the rate of industrial investment and capital accumulation (Todaro & Smith, 2009).

Several countries have succeeded in transforming their economies and their comparative advantage from dependence on primary production, by using their abundant unskilled labour in light manufacturing, such as the ‘Asian Tigers’, including South Korea, Taiwan, Hong Kong, and Singapore, and also China and India (Todaro & Smith, 2009; Stein, 2012). Many SSA countries have, however, as noted in the introduction, yet to see such a structural transformation of the economy. A diversification of SSA exports to labour-intensive manufacturing products and services is argued by many to be fundamental for economic growth in the region (see, e.g., Collier, 2007; World Bank, 2012). An increase in exports would also increase purchasing power to import “capital goods, material imports and consumption goods that can be necessary to spur industrialization and maintain living standards”, and to generate economic development (Milberg & Amengual, 2008, p. 11). Industrialisation and an increase in diversity in production moreover improve the prospects of enhancing trade among African countries with potential significant positive effects on growth (see, e.g., World Bank, 2012).<sup>11</sup>

An increase in higher-productivity, higher-value activity is today an important aim of many SSA countries, together with an increase in net exports and foreign exchange earnings to ease balance-of-payment problems. Large investments are often needed to be able to enter the market as a large-scale producer that is able to compete with well-established manufacturing firms, due to the cost of entering the global market, and internal and external economies of scale.<sup>12</sup> Income levels and domestic saving are, however, very low in many SSA countries making it difficult to accumulate capital and make the significant investments needed to transform the economy. Most SSA firms and countries, moreover, find it difficult to access sufficient capital on the international capital market, and borrowed capital often has high costs due to the risks associated with loans to developing countries. Undeveloped financial markets and credit market failures in developing countries also often prevent domestic firms from obtaining access to capital, inhibiting potential domestic competitive firms to emerge (McConnell & Brue, 2005).

International aid, official loans, and private capital flows from portfolio and direct investment may be important to lessen the gap between domestic saving and desired

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<sup>11</sup> Trade between countries in Africa is very low relative to other regions, and regional integration is a strategic objective for the region (World Bank, 2012).

<sup>12</sup> Internal and external economies of scale depend on the size of the firm and the size of the industry, respectively, and are important factors of trade. Economies of scale exist if there are “economies of growth resulting from expansion of scale of productive capacity of a firm or a industry, leading to increases in its output and decreases in its cost of production per unit of output” (Todaro & Smith, 2009, p. 821).

investments. Portfolio investments have generally favoured high-growth and middle-income countries, and investments are often short-term making the host economy vulnerable to instability in its financial markets. FDI, which EPZs aim to facilitate, offer the possibility for more long-term investments in plants, physical and social infrastructure, and equipment. FDI is today the largest component of international capital flows, and has been an important component of the economic success of the Asian Tigers, China, and India (see, e.g., Aseidu, 2002; Todaro & Smith, 2009; Stein, 2012).

An inflow of FDI not only increases investment in the country, but foreign investors also often bring skilled labour and the technology needed for production. Firms may find it difficult to enter the world market because they lack the necessary knowledge. Such knowledge or ideas may include “insights about packaging, marketing, distribution, inventory control, payment systems, information systems, transactions processing, quality control and worker motivation” (Romer, 1993, p. 544). According to Romer (1993), ‘idea gaps’ are one of the main reasons poor countries remain poor; these may be ameliorated by attracting FDI and multinational companies (MNCs) to the country. Foreign investors bring necessary ideas and skills to the country and MNCs may have important demonstration effects, knowledge leaks, and technology spillovers (Romer, 1993; Todaro & Smith, 2009). A transfer of ideas or technology may generate technological development in the host economy, the main source of productivity growth and long-term economic growth according to neoclassical theories of economic growth (Todaro & Smith, 2009; McConnell & Brue, 2005). The presence of foreign investors may, furthermore, provide access to better knowledge of the global markets. The character, size, and economic importance of MNCs often allow them access to government policy makers and information about global trends to which smaller local firms may not have access. An inflow of FDI, hence, both reduces the gap between domestic savings and the desired level of investment in the host country, and the gap in knowledge between developing and developed countries. However, although an inflow of FDI is generally perceived to improve the prospects of economic growth, the role of MNCs and FDI, and the actual long-term effect of FDI on economic development are debated in the literature. The arguments against private foreign investments as a tool to achieve economic development mainly focus on their potential negative effect on domestic investments, and the vulnerability countries may experience if they become dependent on FDI. MNCs’ use of ‘transfer pricing’ and intellectual property rights, and their potential dominance in local markets is furthermore often argued to diminish the possible positive impact of FDI (see, e.g., Adams, 2009; Todaro

& Smith, 2009).<sup>13</sup> However, as EPZs and similar zones generally only give investors the possibility to locate in specific areas, and sales within the host country often are restricted, the effect of FDI in zones may be somewhat different than FDI in the overall economy. This will be further explored in the next chapters. Being able to have foreign producers somewhat separate from the overall economy is one of the key properties of EPZ programmes, as will be elaborated in the next subsection.

Zone programmes commonly aim to increase a country's competitiveness in industries that can site production just about anywhere. When economies of scale exist, small firms or firms in small clusters of industrial activity often find it difficult to be competitive. An important aim with EPZ programmes is to promote clusters of industrial activity, which is hoped to have a catalysing effect on overall industrial development in the country (see, e.g., Johansson & Nilsson, 1997). Clusters of industrial activity may increase firms' productivity through the ability to support specialized suppliers, pool skilled workers, and transfer knowledge (Krugman et al., 2012).<sup>14</sup> Through upgrading a country's 'hard' and 'soft' infrastructure, the government aspire to improve the countries' ability to handle procedures linked to importing and exporting, and make production and trade more efficient and reliable.<sup>15</sup> Improvements in infrastructure, such as regulatory environment, transport, and communication infrastructure, are together with policies that facilitate trade likely to have a noteworthy effect on the competitiveness and export performance of SSA countries, and hence expected to also impact inflow of FDI (see, e.g., Iwanow and Kirkpatrick, 2009; Nunn, 2007).<sup>16</sup> Successfully improved soft infrastructure, as well as hard infrastructure, even in a limited area, may have a significant impact on how attractive the country appears as a base for investors. By requiring investors to locate in specific areas, and mainly focus on infrastructure

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<sup>13</sup> Transfer pricing is an "accounting procedure usually designed to lower total taxes paid by [MNCs] in which intracorporate sales and purchases of *goods* and *services* are artificially invoiced so that *profits* accrue to the branch offices located in low-tax countries (tax havens) while offices in high-tax countries show little or no taxable profits" (Todaro & Smith, 2009, p. 841).

<sup>14</sup> According to Kingombe and Te Velde (2013, p. 5), "[c]lusters are geographic agglomerations of companies, suppliers, service providers and institutions, linked across the supply chain".

<sup>15</sup> 'Hard' infrastructure includes tangible or physical infrastructure, such as roads, ports, telecommunications and electricity. 'Soft' infrastructure comprises intangible infrastructure, e.g., institutions, customs, transparency practices, and business environments (see, e.g., Portugal-Perez & Wilson, 2012).

<sup>16</sup> According to Nunn (2007), the quality of countries' judicial systems, in particular contract enforcement, have substantial effect on countries' comparative advantage. He finds the quality of judicial systems to explain more regarding patterns of trade than the allocation of countries physical capital and skilled labour combined. Countries with better contract enforcement usually have less underinvestment, and hence lower costs of producing both customized inputs and finished goods. Countries with well-developed judicial systems may for this reason have a comparative advantage in industries where the use of intermediate inputs that require relationship-specific investments is high.

in these areas, costs in infrastructure are also kept relatively low. It is more financially viable for developing countries to upgrade infrastructure in limited areas than to upgrade infrastructure overall. The development of infrastructure and clusters of activity may optimally contribute to change countries' comparative advantages, and increase the countries' competitiveness in higher productivity and/or higher value-added manufacturing or services.

### **1.4 Export-Led Growth and the Development of EPZ Policies**

Many developing countries, including SSA countries, attempted to promote the development of a domestic manufacturing sector and achieve economic development through import-substituting industrialization between World War II and the 1970s. The manufacturing firms that emerged were however often unable to compete in the world market, as the costs of production were often considerably higher than for similar goods elsewhere. The failure of the policies was often a cause of the many obstacles to industrialisation and trade for developing countries, as mentioned in the above subsection. Policies to protect and develop domestic industry for this reason have not enabled most developing countries to catch up with developed countries as predicted by economic theory. The limited success of import-substitution policies resulted in a change in policies, and several countries' trade policies became increasingly liberalised from the mid-1980s (Krugman et al., 2012).

EPZ programmes provide countries with an opportunity to experiment with trade liberalisation, and have been important policies for several countries as they departed from import-substituting policies. As EPZs may be kept separate from the domestic economy, as mentioned above, countries can enjoy the benefits from an increase in foreign investment without liberalising and deregulating the whole economy. The zones have been an important component of several countries' export-led industrialization strategy (ILO, 1998; Jayanthakumaran, 2003). EPZ policies to realise structural transformation of the whole economy were one of the trade policy reforms advocated by the World Bank after 1979; they did, however, also promote economy-wide duty-free import systems as a superior alternative to the zones. The World Bank has supported several EPZ projects, e.g., Colombia, the Dominican Republic, Jamaica, Kenya, and Thailand (World Bank, 1992). However, the use of zones has been the subject of significant debate and critique, also from the Bank itself. The World Bank and several economists have expressed concern about the possible distortion effects that zones generate through the use of subsidies and by allowing countries to delay general liberalisation of the economy as a whole. The ILO has strongly criticised the working



conditions within several zones. The World Trade Organisation (WTO) aims to eliminate the type of export subsidies EPZs are built on, and the associated increase in regional trade agreements does not always harmonise with zone programmes. Despite the critiques and obstacles, the use of zone policies has increased spectacularly over the years (Milberg & Amengual, 2008).

### **1.5 Measures of Performance**

Investments within the EPZs are critical for the zones to be able to have any effect on the host economy. Several studies determine success or failure of zone programmes by their ability to attract investments and by their effects on exports and employment, together with their costs to the host country. The different types of industries established, the different types of employment created, and the value of exports are furthermore often of interest (World Bank, 1992; ILO, 1998). However, zone programmes may succeed in generating employment and foreign exchange earnings, but still have few vertical and horizontal linkages, and hence low probabilities of positive spillovers (Wu, 2009; Omar & Stoever, 2008). The value and amount of local inputs over time, the variety and technical sophistication of the local inputs, and the shifts in industry may give a better indication of the zones' actual effect. Ideally the use of local inputs, and the technological intensity of the local inputs, should increase as the host economy develops (Omar & Stoever, 2008).

Greater diversity in the host country's exports is furthermore often an important target when establishing EPZs. Improved human capital and productivity through knowledge and technology transfers are also often a central aim (ILO, 1998). Zones are however often only one of several tools a country uses to achieve development; it is thus difficult to determine the actual effect of the zones (Omar & Stoever, 2008). The share of exports from and employment within EPZs are likely to decline as the host economy develops and wages increase. The country's dependence on attracting FDI to the EPZs, and its competitiveness, will then decline due to the increase in costs. Favourable location, well-developed infrastructure, and well-functioning administrative services may however potentially ensure that investors remain in the country. Production may adjust to higher labour costs by using more capital-intensive technology, which would contribute to a change in production and increase in labour productivity (Wu, 2009; World Bank, 1992).

## **1.6 Research Question**

The research question this thesis aims to answer is: Do EPZ programmes have the potential to contribute to long-term economic growth in SSA? The thesis addresses the question by answering two sub-questions: Do EPZ programmes provide the benefits anticipated? What factors determine and hamper investments within SSA zones?

## **1.7 Methodology**

The thesis is a qualitative study, though the case studies use available quantitative data for the zone programmes and the respective countries' economic development and trade. The literature review focuses on the most pertinent issues in the academic literature. The thesis tries to include all voices, but space constraints make it difficult to incorporate the extensive literature. Many SSA zone programmes are relatively new and have had less success, and empirical literature regarding SSA zone programmes is for these reasons scarce relative to other zone programmes. My objective with the thesis is to increase knowledge of the use of zone programmes in SSA, and provide a better understanding of the issues related to employment generation in SSA. However, the scarce literature available on SSA zone programmes limits the scope of the thesis to some degree.

Cost-benefit analyses are at times used to evaluate the performance of EPZs. However, as it is often difficult to get hold of adequate data, and as benefits often are indirect, it becomes necessary to make several assumptions that affect the outcome. A cost-benefit analysis may hence be based on estimations and uncertainties, and some benefits and costs may be excluded (Mandani, 1999; Jayanthakumaran, 2003). Different targets and different available data about the zone programmes often make it difficult to compare programmes. For these reasons, the case studies in this thesis do not attempt full cost-benefit analyses or to explicitly compare the respective countries, but rather to interpret the data available.

## Chapter 2

### Literature Review

#### 2.1 The Potential Benefits Linked to the Use of EPZ Incentives

##### 2.1.1 Export Growth and Foreign Exchange Earnings

The relationship between EPZs and export growth is explored in several studies. Some studies find higher growth in exports in lower- and middle-income countries with EPZs than those without such zones, suggesting that EPZs have positive effect on exports (see e.g., Omar & Stoeber, 2008). Johansson and Nilsson (1997) find the presence of zones to have varying effects on total exports, with a significant and positive relationship for some countries, such as Hong Kong, Mauritius, Singapore, and Sri Lanka during the period of study. In other countries in the study, however, the relationship was insignificant most years, or negative, as was found in the Dominican Republic and Mexico. Countries with a positive relationship between EPZs and exports all had an “outward-looking trade policy, characterized by a low degree of trade restrictions” (1997, p. 2121).<sup>17</sup> Johansson and Nilsson argue that “countries with outward-oriented trade strategies are more likely to experience a positive impact on [total] exports”, in contrast to countries that choose to preserve inward-oriented trade policies (1997, p. 2123).<sup>18</sup> Several scholars argue that EPZs need to be part of a greater economic liberalisation process of the whole economy in order to be successful (see, e.g., Jauch et. al, 1996). Johansson and Nilsson also find evidence of a possible catalytic effect of EPZs on domestic exports.<sup>19</sup> SEZs and industrial clusters have further been argued to

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<sup>17</sup> South Korea was an exception. However, exports and employment from the zones only made up a very small percentage of manufacturing exports and employment. The EPZs programme was hence relatively insignificant in the country’s overall trade policy.

<sup>18</sup> Johansson and Nilsson (1997) argue that although zones are profitable they do not necessarily have a long-term positive effect on the host country, as successful zones may allow countries to maintain inward-looking trade policies in general. Low foreign earnings and high unemployment are often important arguments for trade liberalization.

<sup>19</sup> Johansson and Nilsson (1997) find evidence to support the theory that EPZs may have a catalytic effect on domestic exports through positive spillovers, as they find that total export expansion in Malaysia was considerably larger than export growth from the zones alone. Limited available data made it infeasible to look for the effect in the other countries of the study.

be important engines behind the significant growth China has experienced in the last decades (Zeng, 2011).

Foreign exchange earnings are an important aim of many of the zone programmes, and are received through wage payments to the workers, purchases of local intermediate goods, tax payments, and the net profits that go to local shareholders (Mandani, 1999). The ILO (1998, p. 37) however argues that EPZs generate little foreign exchange earnings, as zone investors tend to buy “few local goods and services and the incentives normally provide for full repatriation of profits”. According to Jayanthakumaran (2003), cost-benefit analyses of zones in South Korea, Malaysia, Sri Lanka, China, Indonesia, and the Philippines illustrate that heavy reliance on foreign investors is unlikely to maximize the welfare of a country’s citizens; he therefore advocates a balance between domestic and foreign investors. Chinguno (2009) further argues that the effect of the current global recession shows that developmental strategies based on exports may be unsustainable, and production destined to the domestic market may be more sustainable in the long term.

Another important aim when establishing EPZs is to increase diversity in exports in order to achieve higher economic growth and reduced vulnerability to global changes. EPZs do however often tend to be dominated by just a few industries. Apparel production and electronic assembly have historically been the two main sectors within EPZs. Some countries’ EPZs also produce a large share of their exports for a single market, making the country highly vulnerable to changes in tastes, market access, and recessions in the importing country (ILO, 1998). Preferential access to the US market resulted in the Dominican Republic exporting almost all of its manufactured exports to the US in the 1990s. US investors also made up more than half of the investments within the EPZs. A recession in the US market and a change in consumer demand caused a 20% decline in EPZ employment in 1990–1991 (Kaplinsky, 1993). The ILO (1998, p. 47) argues that EPZ policies would be “more stable and sustainable if the investment was drawn from a wider range of countries and was spread across a broader group of industries and if the output was destined for diverse markets”.

Although SSA zone programmes are argued to be less successful relative to non-SSA zones, several programmes have had a significant effect on exports for the host country. Mauritius’s use of EPZs is often seen as an African success story as the zones were of great significance for the country’s transition from exporting mainly sugar to exporting manufactures such as apparel products, as well as tourism and financial services (Romer,

1998; Rolfe et al., 2004).<sup>20</sup> EPZ policies are furthermore found to have contributed to change in exports in several SSA countries, such as Madagascar and Mauritius. In the beginning of the 1990s, Madagascar exported mainly agricultural products, while manufacturing was marginal. By 2005, manufacturing products, mainly produced within the country's EPZs, constituted half of total exports. About 90% of EPZ production in 2002 was textile and apparel products exported to the US and European markets. The African Growth and Opportunity Act (AGOA) has been important for investments within the EPZs in the country, as is discussed further below (Cling et al., 2005). Farole (2011) finds that although investment level within SSA zones are relatively low, investors in SSA zones are generally from a wider range of countries and investments are spread across more sectors.<sup>21</sup>

### 2.1.2 Employment

Improved employment opportunities are the main target for many developing countries when establishing EPZ programmes. Most countries that have adopted EPZs have been characterized by high rates of unemployment in urban areas and hidden underemployment in the informal sector, as well as a heavy dependence on primary exports and low levels of technical know-how (Jauch et al., 1996). According to Khan (2012), high employment intensity is possibly the most important characteristic of poverty-alleviating growth, as seen in economic successes in Asian countries including the Republic of Korea, Taiwan, Hong Kong, and Singapore.

SEZs employed about 66 million workers in 2006, mainly within developing countries. About 40 million of the workers were employed within zones in China (Stein, 2012). Employment within zone programmes make up a significant share of the formal and manufacturing sectors in some countries, such as the Dominican Republic, Mauritius, and Madagascar (Kaplinsky, 1993; Collier & Venables, 2007).<sup>22</sup> Zones within SSA employed just above a million workers in 2006, more than half of whom were employed within zones in South Africa, as table 2.1 shows.<sup>23</sup> Table 2.1 moreover shows that only zones in Nigeria,

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<sup>20</sup> Romer (1998) argues that the EPZ programme is the only obvious explanation for the economic success of Mauritius.

<sup>21</sup> Farole (2011) draws on research conducted on zone programmes across 10 countries: Ghana, Kenya, Lesotho, Nigeria, Senegal, Tanzania, Bangladesh, the Dominican Republic, Honduras, and Vietnam.

<sup>22</sup> In the Dominican Republic, 105,000 people were employed within the zones in 1989. The EPZ workers made up 56% of total workers employed within manufacturing in the country (Kaplinsky, 1993).

<sup>23</sup> Using data from Boyenge (2007), 1,043,186 workers were employed within zones in SSA, including Sudan and the islands in the Indian Ocean, Mauritius, Madagascar, and Seychelles. Zones in Sudan only employed

Madagascar, Mauritius, Lesotho, and Kenya employed more than 30,000 people (Boyenge, 2007).<sup>24</sup> Kingombe and Te Velde (2013) and Farole (2011) find that absolute and relative employment has been limited in SSA, as one can see in table 2.2, with the exception of Lesotho, which has seen relatively high employment in its workforce.<sup>25</sup> Compared to many other zone programmes, however, SSA zones are young and have seen relatively high increases in employment within the zones in recent years, as can be seen in table 2.3 (Milberg & Amengual, 2008).

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1,033 workers in 2005–2006. Employment data do however vary between sources and the definitions of zone programmes used.

<sup>24</sup> Some SSA zone programmes might only exist on paper, as they never have attracted notable investments, or may have been abandoned by investors (Johansson & Nilsson, 1997).

<sup>25</sup> Zones in Madagascar have also had significant effects on formal employment. The zone programme generated 300,000 jobs between its establishment in 1990 and the political turmoil in the beginning of 21st century (Collier & Venables, 2007).

Table 2.1.  
Employment within SSA zones in 2006

Country	No. of EPZs or similar zones	Total employment
Cape Verde		1,180
Cameroon	1	4,690
Cote d'Ivoire	-	-
Gabon	1	791
Ghana	4	9,828
Kenya	43	38,851
Lesotho	8	44,000
Madagascar	-	115,000
Malawi	1	29,000
Mauritius	-	65,512
Mali	3	17,593
Mozambique	1	-
Namibia	1	29,000
Nigeria	6	111,375
Senegal	-	6,938
Seychelles	-	2,200
South Africa	6	535,195
Sudan	3	1,033
Togo	1	9,000
Zimbabwe	-	22,000

Source: Boyenge (2007)

Table 2.2.  
Employment within zones as a percentage of national employment in the different world regions

	Direct employment (millions)	Percentage of national employment
Global	68,441	0.21 %
Asia and the Pacific	61,089	2.30%
Americas	3,089	1.15%
Central/East Europe and Central Asia	1,59	0.00%
Middle East and North Africa	1,458	1.59%
SSA	1,04	0.20%

Source: Kingombe and Te Velde (2013, p. 6)

Table 2.3.  
Change in EPZ employment by region, 2002–2006

Region	2002	2006	Per cent change
North Africa	440,515	643,152	46.0
SSA	421,585	860,474	104.1
Indian Ocean	170,507	182,712	7.2
Middle East	328,932	1,043,597	217.3
Asia	7,710,543	14,741,147	91.2
China	30,000,000	40,000,000	33.3
Central America	4,490,757	5,252,216	16.9
South American	299,355	459,825	53.6
Caribbean	215,833	546,513	153.2
Eastern and Central	543,269	1,400,379	157.8
Europe			
Pacific	13,590	145,930	973.8

Source: Milberg and Amengual (2008, p. 5)

However, EPZ employment is not necessarily new jobs, and such employment may have been established at the expense or absorption of existing jobs in the domestic economy. Hence, it is important to look at the change in total employment (Jauch, 2002). Chinguno (2009) finds that of 2,000 jobs within South African IDZs, only 1,200 were new. The other jobs existed prior to the establishment of the zones and were merely relocated. Many of the jobs created were also part of the construction of zone infrastructure and likely to be temporary.<sup>26</sup> According to ILO (1998), OECD data show that while employment within the Mexican maquiladoras increased by 10.4% in 1995, manufacturing employment in the domestic economy fell by 9% during the same period. Wang (2013) on the other hand finds the majority of FDI in Chinese SEZs is generating new activities. Kingombe and Te Velde (2013) argue that significant EPZ employment within EPU can be questioned, as it is especially difficult to construct a counterfactual. EPZs are furthermore argued to attract mainly short-term, ‘footloose’ investments, that is, industry that is not tied to a location and that easily can relocate if better conditions appear elsewhere without significant effect on

<sup>26</sup> South Africa’s IDZ programme aimed to create 20,000 new jobs by 2014, but by 2009 the programme had had produced little job creation and little effect on the severe unemployment rate in the country (Chinguno, 2009).



input factors or costs. This is a major criticism of the EPZ policy as it forces countries to continually compete with each other. Footloose industry is highly sensitive to changes in the cost of production, and jobs created may consequently provide little employment security for the worker (Rolfe et al., 2004).

EPZ firms have been heavily criticised for exploitation of workers, paying them negligible wages and providing poor working conditions. The prevalent violations to labour and social rights have contributed to making the zones unpopular in several of the countries where the policies have been adopted (see, e.g., Chinguno, 2009; Jauch, 2002).<sup>27</sup> According to Warr (1989), however, many fail to take into account the employment possibilities and wages in poorer countries, and that workers are likely to be better off with EPZ employment than with no employment. Wages and benefits within the zones should be compared to those in the domestic economy and the unemployment rate taken into account in order to see the alternative for the workers. McCallum (2011) argues that as many of the investors in the zones are multinational companies they will be subject to more political awareness and pressure to pay at least the local minimum wages. Several studies find wages to often be higher and benefits to be better within zones than those in similar employment in the domestic economy (McCallum, 2011; Milberg & Amengual, 2008).<sup>28</sup> Milberg and Amengual (2008) do however find that workers within EPZs tend to work longer hours, often illegally, and further highlight that compliance with minimum wages does not necessarily imply that the workers receive wages that are possible to live well on. Cling et al. (2005) do not find wages within zones in Madagascar to be significantly different from industrial firms in the formal sector outside the zones. They argue in contrast to the critique that the zones in Madagascar seem to have been important in improving the working conditions in the country. They do however emphasise that the effect EPZs may have on working conditions may be very different in low- and middle-income countries.

Women make up to 70–90% of the workforce in some zones and employment within EPZs has been suggested to have the possibility of improving the social status and the economic power of women. The questionable quality and job security of EPZ employment does however make scholars argue that such employment does not necessarily contribute to the empowerment of women (Milberg & Amengual, 2008; Jauch, 2002). The development of

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<sup>27</sup> Several studies find EPZs to be characterised by high labour turnover, labour unrest, absenteeism, stress, and low productivity (Jauch, 2002).

<sup>28</sup> According to Milberg and Amengual (2008), wages tend to be higher among EPZ workers than among workers in the domestic economy, in, among others, Bangladesh, Costa Rica, Honduras, Madagascar, and Sri Lanka.

the zones furthermore often results in an increase in the proportion of men over time as technology evolves and become more advanced (Kusago & Tzannatos, 1998).

### 2.1.3 Backward Linkages

A number of studies highlight the importance of encouraging the development of ‘backward linkages’, that is the use of local raw and intermediate goods by the EPZ firms, as these are found to be crucial to increase the net benefit of the EPZ programmes.<sup>29</sup> According to Farole (2011, p. 12), “policies to promote links between SEZs and the domestic economy are key to realizing the dynamic potential of the zones”. One of the main incentives to attract investors is duty-free import of raw and intermediate goods. Hence, local producers may find it difficult to compete with high-quality goods available at a low price from abroad. Watson (2001) argues that for this reason backward linkages are more likely to exist in more developed economies, with better prospects of producing quality inputs, and not necessarily in less developed countries. This is also supported by Milberg and Amengual (2008), who find that EPZs are more likely to enhance economic growth in countries with higher levels of industrial development. Industrial development may increase both available inputs and the domestic capacity to absorb positive spillovers. This is consistent with studies of the effect on economic growth of FDI to the overall economy; see, e.g., Alfaro et al. (2004), Hermes and Lensink (2003), and Xu (2000).

A study of the EPZs in the Dominican Republic finds that even though the zones had a great effect on export levels, the zones had few linkages to the domestic economy, as they were merely enclaves outside the economy. The effect of the zones on the domestic economy was for this reason limited (Willmore, 1995). For the same reason Chinguno (2009) argues that the effect the zones in South Africa have on the economy is limited. Firms producing textiles and garments as well as electronics, which dominate many of the EPZs, have been found to have a low propensity to form backward linkages (Jenkins, 2006).<sup>30</sup> Jenkins (2006) argues that low use of local inputs can be explained by the price of raw materials, components, and intermediate products within the sectors. The prices on these products tends to be high relative to their weight and volume, and it is thus “comparative[ly] less expensive” to take advantage of differences in costs across nations (Jenkins, 2006, p. 333). Farole (2011) finds the use of local inputs to be higher in African zones than in non-African zones, mainly

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<sup>29</sup> Domestic sales are typically restricted from EPZs. Forward linkages are hence often limited.

<sup>30</sup> The propensity is measured by the likelihood of firms to purchase raw materials in the local market.

due to a higher share of the food and beverage sector within African zones. If only comparing firms within the garment sectors, the use of local inputs tends to be lower in African zones relative to non-African zones.

Backward linkages depend on different factors. The age of the enterprise is positively correlated with the share of local raw materials used in production, suggesting that firms become gradually “more acquainted with the local environment and the ways of doing business” with time (Jenkins, 2006, p. 333). Jenkins (2006) moreover finds that a firm’s capital intensity is positively and significantly correlated to the propensity to form backward linkages, and argues that capital-intensive firms are likely to be less footloose and likely to remain in a country for longer. Smaller firms and firms that sell a larger proportion of their output in the domestic market are furthermore more likely to use higher shares of local inputs (Jenkins, 2006).

#### **2.1.4 Transfers of Knowledge and Technology**

Transfers or spillovers of knowledge and technology from FDI may be important engines of growth. Factories within an EPZ are most often labour intensive, using noncomplex manufacturing processes, such as in textile and garment production and electronic assembly, as mentioned above. Easterly (2002) argues that the substantial growth in garment production in Bangladesh in the 1980s was rooted in knowledge leaks from South Korean investors.<sup>31</sup> Local workers learned how to produce textiles at a low cost, and how to enter the world market. Several of the workers trained by South Korean investors ultimately set up their own apparel-export firms, contributing to significant growth in manufacturing. Transfers of ideas or knowledge also had significant effect on apparel production in Mauritius, contributing to an increase in manufacturing and economic growth in the country (Romer, 1998). Other studies do however find little evidence of horizontal spillovers from FDI, or transfers of knowledge and technology to local competitive firms, e.g., Harrison and Rodrigues-Clare (2009). According to Winkler (2013) spillovers from FDI depend on the extent, durability, and quality of linkages between foreign investors and the domestic economy.

LaRRI (2000) argues that most EPZ workers’ training is often limited to a specific task and not easily transferable. EPZ investors often require being able to use their own nationals in managerial and technical positions, perhaps to avoid the costs of training and to

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<sup>31</sup> The South Korean investors settled in Bangladesh to circumvent garment import quotas from the US and Europe (Easterly, 2002).

maintain greater flexibility to move production (Jauch et al., 1996). Management- and advanced technical training do of these reasons tend to only happen on a small scale, with little effect on skill levels (Kusago and Tzannatos, 1998). Research and development facilities are moreover likely to be kept within developed countries when production is moved to countries with low-cost labour. This limits technological spillovers to the developing country (Wu, 2009). According to Fosfuri et al. (2001, p. 220), there is a heightened possibility for technology transfers to occur when “on-the-job training is general rather than specific, and when the absorptive capability of the local firm is high”. The process of learning or adapting new technology may induce significant costs in the short-term for domestic firms. The government in the host economy should aim to expand the opportunities and the capacity of domestic firms to learn from EPZ firms (Liu, 2008; Omar & Stoeber, 2008; Warr, 1989).<sup>32</sup>

## **2.2 Potential Economic Costs Linked to the Use of EPZ Policies**

The different incentives given to attract investors are not necessarily in harmony with a country’s developmental interests, and might impose significant direct and indirect costs on the host country. The costs of establishing the necessary infrastructure to attract investors are often substantial. Administrative costs and the costs of offering subsidised services may significantly increase the costs of zone programmes, if appropriate levies are not paid. There are furthermore several indirect costs linked to the establishment of zones, as zone incentives can potentially cause economic distortions. EPZ policies may cause a loss of government revenue from taxes and from import and export duties, if tax concessions are given to firms that would locate in the country regardless of the incentives. Zone programmes may moreover attract firms that would not be competitive without the given incentives (World Bank, 1992; Watson, 2001). The direct and indirect costs linked to the zone programmes are determined by the incentives given, as is further elaborated in section 2.3.

The number of private zones has increased significantly in the last years, as mentioned in the previous chapter. The World Bank (1992, p. 9) argues that risks and costs for the host country will “largely disappear when private entrepreneurs assume responsibility for developing and managing EPZs”. Private EPZs are found to be more efficient and less expensive for the host country, as well as to attract higher-quality investments. However,

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<sup>32</sup> According to Liu (2008), the cost of learning causes the effect of FDI on domestic firms to often be negative in the short term, The long-term effect is however positive. This may explain why some studies, e.g., Bwalya (2006), find a negative effect on local firms’ productivity from the increase in number of foreign-owned firms.

whether zones are under private control does not seem crucial for their success, as the zones in Mauritius and many East Asian zones are publicly controlled. About 60% of the zones in the world today are privately owned. African zones are almost equally split between public and private zones (Farole, 2011).

There are also concerns that zones attract industries that aim to avoid environmental regulation in their home country. Poorer countries often have weaker environmental laws, or may often lack the capacity or knowledge to implement them. The result may be that negative externalities are not internalised by those responsible, and the population in the host country is left carrying the environmental costs notably reduce the net benefit of establishing zones (Mandani, 1999; Wu, 2009). The pollution levels linked to zones have generated concern for some zones, for example, the levels of pollution surrounding the maquiladoras in Mexico (Mandani, 1999). The World Bank (1992, p. 8), however, argues that the concerns about the zones' environmental impact seems to be unfounded and finds no "evidence that EPZs systematically exempt firms from environmental regulations or that firms that locate there are heavy polluters". In its 1992 report, the World Bank further asserts that clusters of activity, on the contrary, can reduce costs of control of pollution and disposal of hazardous industrial waste, and that if environmental problems exist, they are due to economy-wide policies and use of resources, rather than EPZs.

## **2.3 The Determinants of Investments**

### **2.3.1 The Role of Traditional EPZ Incentives**

Despite significant investments in zone infrastructure and services at times, zones in SSA have mostly seen low inflows of both foreign or domestic investments, and the economic effects of several of the zone programmes so far have been disappointing. However, though the absolute level of foreign investments within African zone programmes is relatively low, foreign investments within the zones tend to make up a relatively high share of total foreign investments in the country (Farole, 2011). Hence, Farole (2011, p. 71) argues that "the relative failure of the African SEZ programs to attract investment may be due to a poor overall investment environment than to the failure of the zone programmes themselves". Several factors have been found to hamper investment in African zones, such as "insufficient incentives and promotion, poor location, inadequate trade policy reforms in the host country, inefficient bureaucracy and inadequate infrastructure" (Kinunda-Rutashobya, 2003, p. 228).

Most of the successful zones have common features including “favourable location, adherence to the basic EPZ principle, i.e. duty-free imports of inputs, minimized red-tape procedures, guaranteed profit repatriation and the presence of a supporting infrastructure such as telecommunication, electricity and water” (Johansson & Nilsson, 1997, p. 2118). A study of the investors in the Caribbean Basin finds that investors tend to prefer countries with low labour costs, relatively long tax holidays, and relatively large zones (Woodward & Rolfe, 1993). Woodward and Rolfe (1993) argue that EPZ incentives such as tax holidays and guaranteed profit repatriation may have an important signalling effect regarding the host country’s attitude towards FDI and affect the perceived business environment. Rolfe et al. (2004) furthermore find that most investors within Kenyan EPZs preferred a tax holiday followed by high tax rates to infinitely low taxes. This may suggest that investors put emphasis on short-term gains or plan on exiting the zones at the end of the tax holiday, which is consistent with the footloose nature one tends to find within EPZs. Farole (2011) does not find traditional zone incentives such as low wages, trade preferences, and fiscal incentives to be correlated with the success of the EPZs, rather, other incentives, including infrastructure, have greater significance for success. Woodward and Rolfe (1993) report that investors in the Caribbean Basin preferred countries that already had a high concentration of manufacturing, signifying that foreign investors favour agglomerations and the existence of external economies of scale. Hence, countries with relatively low levels of manufacturing may have a disadvantage to other countries where that sector is more developed.

### **2.3.2 Domestic Sales and Domestic Investments**

The size of the domestic market is found to have a positive effect on investment within the zones, as larger markets supports large-scale production and infrastructure (Milberg & Amengual, 2008). This is consistent with the results from other studies of determinants of FDI, e.g., Asiedu (2006). Most African countries, however, are small, both in terms of population and in terms of GDP (Rolfe et al., 2004; Asiedu, 2006). According to Rolfe et al. (2004), the ability to sell goods in the domestic market does not affect the decision of apparel investors to invest, and only has a negligible effect on non-apparel investments in Kenya. The effect of allowing greater domestic sales is disputed. Improved access to low-priced goods from the EPZs can be beneficial for domestic consumers, but may also potentially prevent domestic producers from developing (ILO, 2003). Larger domestic sales from the EPZs may also increase linkages to the economy, as found by Jenkins (2006).

The share of local investments has increased and become more important in a number of zones over time, e.g., Mauritius, Malaysia, and the Republic of Korea, and is now increasing in zones in China, Bangladesh, and Vietnam. Domestic investments are argued to be essential for greater integration between the zones and the domestic economy, as they provide greater benefits for local firms and contribute to a higher share of revenues transferred to the domestic economy (Wu, 2009; Farole, 2011). Jenkins (2006) finds empirical evidence that firms owned mainly by local investors are more likely to purchase intermediate inputs from the local market, increasing the likelihood of backward linkages to the economy. Jayanthakumaran (2003) argues that the national interest in EPZs is likely to persist if the zones generate private profit to domestic shareholders and are more beneficial for the country in the long term.<sup>33</sup> Many African zones have a relatively high share of local investments from the beginning, and the majority of investments within zones in Senegal, Tanzania, and Nigeria remain domestic. The relatively high share of local investors may indicate a failure to attract foreign investors, but also that local firms have been given EPU status (Farole, 2011).

### **2.3.3 Labour Costs, Productivity, and Working Conditions**

Attempts to attract foreign investments by offering access to cheap labour in SSA may not be sufficient if other EPZs offer more favourable productivity and unit labour costs (Jauch, 2002). SSA has relatively low labour costs but also low labour productivity, and labour costs tend to be higher than what is predicted by the income level and labour productivity, at least when compared to East Asia (Clarke, 2012; Cling et. al, 2005).<sup>34</sup> Some scholars attribute the relatively high labour costs to the large natural resource endowments in many SSA countries, as will be elaborated below. According to some scholars, SSA countries may be more competitive in industries that take more advantage of the countries' natural resources than its surplus labour, as is further elaborated below. Watson (2001) does on the other hand argue that low levels of skilled labour and low levels of productivity do not imply that light manufacturing is not suited for Africa. According to Watson (2001), skills and productivity have improved steadily in countries in Asia and the Caribbean where EPZ programmes have been successful, and can also take place in Africa.

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<sup>33</sup> The interest in EPZ programmes will, according to Jayanthakumaran (2003), tend to disappear with industrial development, due to the reduction of the gap between the market and opportunity costs of labour.

<sup>34</sup> Clarke (2012) finds labour productivity in many SSA countries to be relative high compared to other countries with similar income levels. However, wages are also higher reducing the firms' competitiveness in the global market. If one compares per unit labour costs as a reflection of the competitiveness of labour, all countries in Africa have a disadvantage relative to China, according to Ramachandran et al. (2009).

Several countries partly or fully suspend labor rights within the zones to attract investment, e.g., India, Bangladesh, Zimbabwe, Kenya, and Namibia. Union activity in these countries is often banned and minimum wages are not applicable (LaRRI, 2000).<sup>35</sup> According to the World Bank (1992), for the zones to be successful, it must be easy to hire and retrench workers, and regulatory interventions and controls within the zones must be minimal. Jauch et al. (1996) claim that use of EPZs is only “likely to lead to down spiral of labour standards” in SSA due to competitive pressure (1996, p. 48). Poor labour standards within the zones, and the potential for the vast numbers of zone programmes to cause a further weakening of labour rights are a matter of concern and critique of the use of zone programmes and also of the firms utilizing them (see, e.g., ILO, 1998). Poor labour conditions are also a potential source of conflict, which should be taken into consideration by the government (LaRRI, 2000).

#### **2.3.4 Infrastructure**

Farole (2011) finds a strong correlation between infrastructure quality and levels of investment, exports, and employment within SEZs. He argues that poor infrastructure has detrimental effects on investment levels in many SSA zones. Collier and Venables (2009) find energy and transport prices to be relatively high in Africa, due to the failure to take advantage of economies of scale and to pool risk for public goods. This disadvantage is a result of many African countries being small and undeveloped. Electricity supply in SSA is also often relatively unreliable, and as energy is a fundamental input in most manufacturing, energy supply and pricing may have a severe effect on the competitiveness of African manufacturing firms (Farole, 2011).<sup>36</sup> The EPZ concept may be an attractive policy for African governments because it is easier to improve infrastructure in one specific area than the whole country (see e.g., Watson, 2001). The use of EPU may increase the “logistical challenges of addressing investment climate challenges, [such as] special customs clearance regimes, one stop services and reliable infrastructure” (Farole, 2011, p. 148).<sup>37</sup> However there is no clear evidence in the

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<sup>35</sup> LaRRI (2000) finds reduced labour rights to be a central incentive for industries within zones in many countries.

<sup>36</sup> Data from surveys show a 50% downtime across African EPZ firms caused by electricity failure, significantly increasing the cost of production, according to Farole (2011).

<sup>37</sup> African countries as Ghana, Kenya, Tanzania, Mauritius, and Senegal are among the countries using single factory units or EPU (Mandani, 1999). As Mauritius is a small island, it is however relatively easy to access key infrastructure, such as the airport and port, no matter where the investor locates within the country (Farole, 2011).



literature that having EPU makes a difference with respect to investments or the net benefit of the zone programmes (see e.g., Farole, 2011; Rolfe et al., 2004).<sup>38</sup>

Soft and hard infrastructure may have major impact on transport, logistics performance, and trade facilitation, which in turn have potentially important impacts on trade costs. Trade costs moreover affect patterns of trade and investments, by affecting countries' "ability to take part in regional and global production networks" (Arvis et al., 2013, p. 3). The cost of trade is also determined by location, as is further discussed below. The average trade costs for manufactured goods to the top 10 import countries, between 1996 and 2009, are estimated to be considerably higher from SSA than other regions. Many African ports have relatively low performance, and many African zones lack on-site customs (Farole, 2011). Landlocked countries within Africa may experience a further disadvantage (Watson, 2001). Farole (2011) finds that the reported time needed to clear imports from customs was considerably higher in the studied African countries' SEZs than non-African SEZs.

### 2.3.5 Location

The geographic position of the host country may have significant impact on the amount of investments the zones are able to attract. Locating close to the finished goods' markets gives firms the opportunity to reduce transport costs and shorten delivery time, and these benefits may make some zones preferable to others, and can also compensate for higher taxes or labour laws in the zone (Mandani, 1999). According to Sargent and Matthews (2004), geographical proximity to rich industrial areas gives zones an advantage relative to competing zones, which may keep investors within the EPZs even when relative costs increase. Hence, countries close to larger markets may be more likely to experience a shift to higher-value-added and technology-intensive production.<sup>39</sup> Kaplinsky (1993) argues that the Caribbean and Central America have a comparative advantage relative to Asian countries, due to their proximity to the US, which allows them to have higher wages relative to those in developing Asian countries.

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<sup>38</sup> Farole (2011, p. 73) does not find any "strong evidence that enclave models are more or less effective than single factory models on a national basis". Rolfe et al. (2004) furthermore do not find the freedom to locate anywhere in the country to have significant effect on investments, neither in apparel nor non-apparel sectors in Kenya.

<sup>39</sup> Sargent and Matthews (2004) find that when costs increased for the *maquiladoras* in Mexico, the firms producing goods for regional or regional and global markets were better able to secure investors than those that produced only for global markets, supporting the notion that proximity to the market may have a significant impact on a region's ability to compete for investments with other regions.

A possible comparative advantage for SSA is the region's abundant natural resources, and hence proximity to raw materials. Manufacturing activities related to the region's natural resources could potentially be very advantageous for African zones and better utilize domestic capacity (Farole, 2011; Dihn et al., 2012; Chinguno, 2009). Some African countries have incorporated their natural resources into zone activities; for example, Ghana has managed to attract significant foreign investment in activities related to natural resources such as cocoa, wood, and fish. Nigeria has also had success with a zone established to act as a trans-shipping point to service the oil and gas industry in the country. Other industries in Ghana and Nigeria have not been able to attract a comparable level of investments (Stein, 2012; Farole, 2011).

### **2.3.6 Location within the Country and Regional Development**

Location within the country may also affect how attractive zones appear for investors, and poor location is one of the main reasons given in the literature for failure of zone programmes. Foreign investors tend to favour agglomerations, access to quality infrastructure, and deep labour markets. Productivity furthermore tends to be higher in clusters of economic activity, due to lower transport costs, improved communication, and positive learning externalities, among other factors (Collier & Venables, 2009). Most zones are located close to trade gateways such as ports or airports, to provide good access to the global market. EPZ programmes are however sometimes used to generate an inflow of investment and an increase in employment opportunities in areas with low levels of economic activity (see, e.g., World Bank, 1992). The location of zones may have a significant impact on the net benefit of the project. The cost of establishing the necessary infrastructure in the area of the zone is radically higher if no prior infrastructure exists there, than if a more developed area is chosen. Furthermore, less developed areas most often do not offer easy access to skilled labour or well-developed infrastructure (Kusago & Tzannatos, 1998; Jayanthakumaran, 2003). Zones used as a tool to create regional development in less developed and more remote areas have rarely been successful because of these reasons, e.g., in Nigeria, Bangladesh, Vietnam, Dominican Republic, and Lesotho (World Bank, 1992; Farole, 2011).<sup>40</sup>

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<sup>40</sup> Studies find the net benefit of the zones in Philippines to be negative due to very high costs, as infrastructure was built from scratch. In contrast, zones in Korea and Malaysia used existing infrastructure or located zones in areas close to existing industrial areas and were able to keep costs significantly lower (Kusago & Tzannatos, 1998; Jayanthakumaran, 2003).

### 2.3.7 Political and Economic Stability

“A suitable macroeconomic, exchange rate, and trade *policy regime*, together with a legal and regulatory environment favorable to business” is argued by the World Bank (1992, p. 10) to be critical for developing countries to build a manufacturing sector able to export to the world market. Woodward and Rolfe (1993) find empirical evidence that inflation had a negative effect on investments, while a depreciation of the exchange rate had a positive effect on investments within zones in the Caribbean Basin. A competitive real exchange rate is found to be key for export growth, and is especially important for exports of modern services according to Eichengreen and Gupta (2013). Exports of natural resources, which are relatively abundant in many SSA countries, may lead to an appreciation of the local currency and higher costs of living, and consequently higher labour costs compared to other countries. The inflow of foreign aid and monetary policies may moreover contribute to the effect (Nduli et al., 2007; McMillan & Rodrik, 2011).<sup>41</sup> Stein (2009) argues that many African governments make too-frequent shifts in policy, reducing investors’ confidence that favourable EPZ policies will persist, and that continuity is needed.<sup>42</sup> In some SSA countries, opposition parties and the media have been critical of EPZ policies, showing a lack of consensus and concerted action with possibly negative effect on investments, e.g., in Namibia and South Africa (LaRRI, 2000; Chinguno, 2009). According to Aseidu (2002) overall FDI to SSA is impeded by the perception that investments in region are of higher risk. Political unrest has affected investments within SSA countries. Mandani (1999) notes that foreign investment in Togo and in Zaire, today the Democratic Republic of Congo, were considerably affected by political unrest in the early 1990s. A political crisis in Mozambique in 2000, after a presidential election, also had a severe effect on investment and production levels within the zones, and caused about 70% of workers within the EPZs to lose their jobs. Investment levels did however later recover some (ILO, 2003; Cling et al., 2005).

### 2.3.8 Trade Agreements

Trade agreements may have significant positive impact on countries’ competitiveness, by giving some countries preferential access to certain markets. Trade policies may hence affect how attractive the countries appear for investors. There are several agreements with

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<sup>41</sup> According to McMillan and Rodrik (2011), Asian countries in general have competitive currencies that have contributed to a structural change of the economy, while several African countries have overvalued currencies.

<sup>42</sup> According to Watson (2001) several existing and potential investors express worry that African governments may fail to maintain incentives, infrastructure, and services.

potentially significant effects on African trade, among them the Cotonou Agreement, AGOA, and the Everything But Arms (EBA) agreement. Prior to 2005, the Multi Fiber Arrangement (MFA) also contributed to reducing the competition African countries met from Asian countries, among others (McCormick et al, 2006). Jayanthakumaran (2003) finds a strong correlation between the growth of EPZs and the MFA, and finds the MFA to have a significant effect on global production patterns of apparel products, as firms moved overseas to obtain access to the quota shares under the MFA.<sup>43</sup> AGOA was initiated in 2000, providing eligible SSA countries duty-free quota-free access to the US market.<sup>44</sup> The effect of the AGOA has however been concentrated within textile and apparel exports, and in a few countries, specifically: Kenya, Mauritius, Madagascar, and Lesotho (Collier & Venables, 2007). Cling et al. (2005) argue that beneficial access to large markets, through mainly AGOA, was one of the main factors that contributed to the EPZ policies being relatively successful in Madagascar. According to Collier and Venables (2007) AGOA has been critical in keeping investors and levels of exports in African zones after the phase-out of the MFA.

The EBA agreement was initiated in 2001, giving countries classified as least developed countries (LDCs) by the United Nations (UN) duty-free access to the European Union (EU) market for almost all types of exports. The agreement has had less noteworthy effects on African processed exports than the AGOA. Collier and Venables (2007, p. 1335) argue that LDCs are less likely to be able to take advantage of preferential market access than more developed countries in Africa, if given access, as they are “least likely to be near the threshold of global manufacturing competitiveness”. In contrast to the AGOA, the EBA agreement also applies a rule of origin for textile and apparel exports to LDCs “justified as a means of supporting more processing in developing countries” (Portugal-Perez, 2008, p. 21). The rule of origin has significantly depressed textile and apparel exports to the EU according to Portugal-Perez (2008).<sup>45</sup> The end of the MFA in 2004 had a significant effect on garment-sector exports in SSA. Apparel exports in East and South Asia, especially Bangladesh, Vietnam, and Cambodia, together with China grew rapidly between 2004–2008, while other regions such as Central America, the Caribbean, and SSA experienced declines of up to 40% in exports and large losses in market share (Farole, 2011; Milberg & Amengual, 2008).

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<sup>43</sup> According to Mandani (1999), NAFTA had a positive effect on employment and exports in zones in Mexico, and a negative effect on Caribbean and Asian zones.

<sup>44</sup> See appendix for more information about AGOA.

<sup>45</sup> The appendix contains more information on the different agreements mentioned in this chapter. Table A1 gives an overview of SSA countries' eligibility for AGOA and/or EBA benefits.

According to Milberg and Amengul (2008) non-East Asian countries are still at great risk of losing significant shares in the world export market to countries like China.

### 2.3.9 Timing and Number of Competing Zones

The timing of the establishment of the zones in Africa is a possible explanation for why SSA zones have not been more successful. Many of the zones with the greatest success, in East Asia and Mauritius, were established in the 1970s, when there were fewer zones to compete with. The majority of SSA zones, with the exception of those in Senegal and Lesotho, were established much later, during the 1990s, when competition between the zones to attract investors was much higher, as seen in table 2.4 (Wu, 2009; Farole, 2011). On the other hand, zones established at a later stage have the advantage of learning from the experience of others (World Bank, 1992; Chinguno, 2009).

Table 2.4.

Overview of African Zone Programmes by Decade of Launch

1970s	1980s	1990s	2000s
Liberia	Djibouti	Burundi	Gabon
Senegal	Togo	Cameroon	Gambia
Mauritius		Cape Verde	Mali
		Equatorial Guinea	South Africa
		Ghana	Zambia
		Kenya	
		Madagascar	
		Malawi	
		Mozambique	
		Namibia	
		Nigeria	
		Rwanda	
		Seychelles	
		Sudan	
		Uganda	
		Zimbabwe	

Source: Farole (2011, p. 68).

The noteworthy increase in number forces the different zones to compete with each other and offer costly incentives without necessarily being able to attract sufficient

investments. The net benefit of the zone programmes may decline with the increase in the number of zones. The attempt to offer incentives superior to other zones is called the ‘race-to-the-bottom effect’ and traditional EPZ incentives, such as low labour costs, trade preferences, and fiscal incentives are argued to be unsustainable (Jauch, 2002; Wu, 2009). Kaplinsky (1993) argues that countries may experience a *competitive disadvantage* if a number of countries attempt to exploit their unskilled labour by attracting labour-intensive production at the same time. In the same way, it will lead to little gain for the country to devalue its currency if a number of other countries do the same. He argues that the most viable alternative is to increase industries that do not merely rely on unskilled workers, but use different types of skilled workers. According to Wu (2009), the increase in competition no longer makes it beneficial to establish EPZs that mainly rely on low-cost labour. There are also concerns that the increase in competition will diminish attention to workers’ rights and will lower wages, significantly reducing the gains of EPZ employment for the worker (McCallum, 2011). Farole (2011, p. 89) argues that SSA zones may have been “too late to take advantage of the massive globalisation of manufacturing that accelerated during the 1980s and 1990s”. However even for successful zones it has taken time for investments to increase, for example in Malaysia and China. Farole (2011b) finds the age of zones to be positively correlated with export volume, but that age alone does not explain the vast differences in the outcomes of the zone programmes.

## 2.4 Conclusion in the Literature

According to Kingombe and Te Velde (2013) SEZ programmes can both generate employment and contribute to structural transformation. They do however find that most SSA zone programmes have failed to increase higher-productivity activities, with the exception of Mauritius and possibly Kenya. They argue that successful zone programmes must be able to respond to changes in the global economy, be part of a wider growth strategy, and take advantage of economies of scale. Watson (2001) argues that obstacles to successful EPZ programmes and manufacturing in SSA are not intrinsically African and can for this reason be overcome, and have a subsequent positive effect on long-term development. Stein (2012, p. 339) is positive regarding the effect of EPZs in Africa, and argues that successful zones have shown they may have significant “impact on the structural and institutional transformation of African economies”. He does however stress that EPZs “should not be seen as a panacea for solving the diverse and complex economic problems for all African countries” (Stein, 2012, p.

339). Farole (2011) furthermore concludes that despite the weak performance of most African zones to this day, they do have a potential to be useful for many African countries. However, other authors are more critical about the effect the zones may have for African economies. LaRRI (2000) argues that neither employment nor backward linkages justify the considerable costs that the EPZs programme in Namibia incurred. LaRRI claims that the government's expectations for the EPZ programme were highly optimistic and based on rather unrealistic projections. They do however note that their study was done in the very early stages of the Namibian EPZ programme. According to Jauch (2002) EPZ programmes have no prospects for solving the socioeconomic problems in Southern Africa, and he argues that use of zones will only result in a race to the bottom, with detrimental effects on regional cooperation, self-sufficiency, and sustainable development. Jauch et al. (1996, p. 47) argue that the huge disbursements EPZs require can "be used more productively and more efficiently on larger scale national employment creation programmes".

Collier and Venables (2007) recognize that EPZs may not be sufficient to significantly increase manufacturing, but be more a necessity as Asian countries already have such zones. They emphasise the need for trade preferences for Africa to be able to increase manufacturing in SSA. However, due to its high wages relative to productivity and high transport costs, several scholars question SSA's competitiveness in labour-intensive manufacturing. It is argued that SSA is more likely to be competitive in manufacturing industries that take advantage of Africa's access to natural resources (e.g., Dihn et al., 2012; Chinguno, 2009). The somewhat different results and conclusions in the literature regarding the impact of EPZs may be to some extent explained by the use of different models and/or assumptions. The context and EPZ policies also vary between countries, and EPZ policies will for this reason not necessarily have the same effect in different countries.

## Chapter 3

### Case Study – Kenya

#### 3.1 Kenya's EPZ Programme

##### 3.1.1 Introduction

Kenya is known as the regional hub for trade and finance in the East African region, and as a popular tourist destination due to its outstanding wildlife. It is a low-income country with a population of about 41.6 million people.<sup>46</sup> The country's main exports are tea, horticultural products, coffee, tobacco, and textile and apparel items. Tourism also provides an important source of foreign exchange earnings. Agriculture still dominates and provides the main source of employment in the country, as was the case when the country became independent from Britain in 1963. However, the country has seen an increase in both the manufacturing sector and the service sector, reducing the dependency on subsistence agriculture (AEO, 2012a; KEPZA, 2012; World Bank, 2013c). Poverty remains urgent: 46% of the population lived on less than one dollar a day at the end of the first decade of the 21st century. Inequality is also high, especially between rural and urban areas (International Monetary Fund (IMF), 2010; World Bank, 2013a, 2013c).

The country has implemented a number of structural adjustment programmes (SAPs) since the mid-1970s to improve the economic growth rate and reduce government debt. Poor economic growth and a drop in GDP per capita at the beginning of 1990s (see figures 3.1 and 3.2) resulted in several measures to improve economic performance.<sup>47</sup> During the 1990s reforms were implemented to increase private investment and to move from import substitution to an export-led growth strategy. Numerous publicly owned companies were also privatised. All administrative controls on international trade, such as foreign exchange allocation, price controls, and import licensing, were removed by 1993. The aim was to accelerate the process of industrialisation, generate employment, reduce poverty, and further integrate the country into the global economy (Mwenga & Ndung, 2001).

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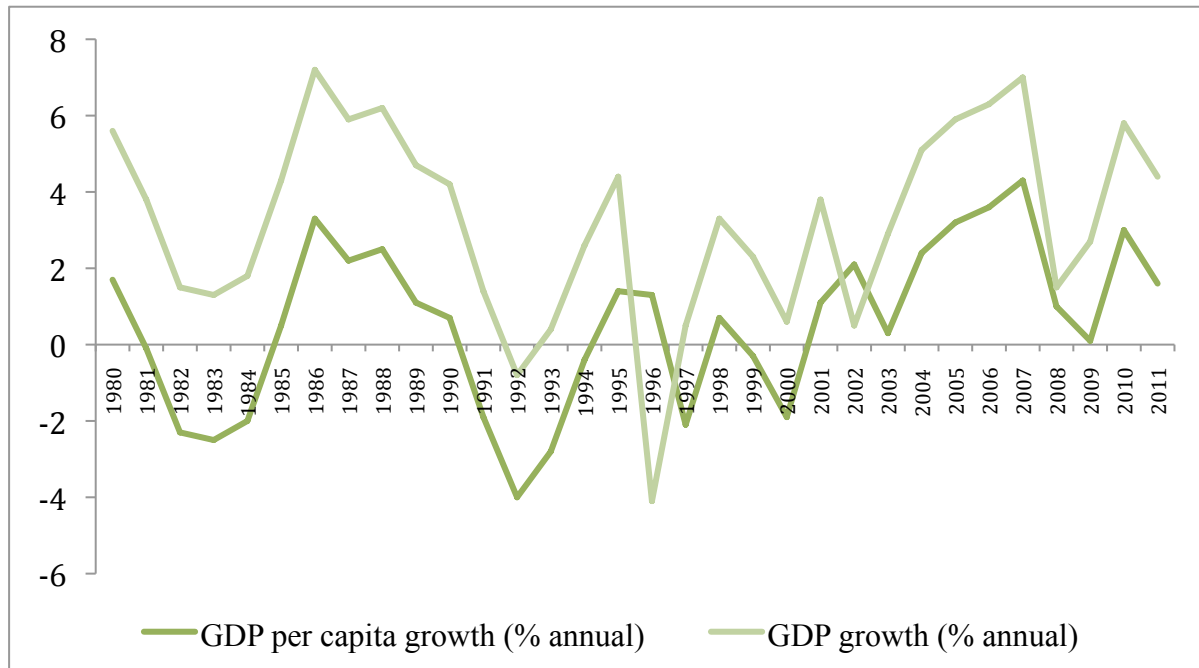
<sup>46</sup> Kenya has a GDP per capita of US\$808 (current dollars) (World Bank, 2013a).

<sup>47</sup> Kenya has seen a positive economic growth rate on average in the period 1980 to 2011, but the growth rate has seen large fluctuations. The level of GDP per capita notably dropped in the 1990s, before increasing again beginning in 2003, as figures 3.1 and 3.2 show.



Figure 3.1.

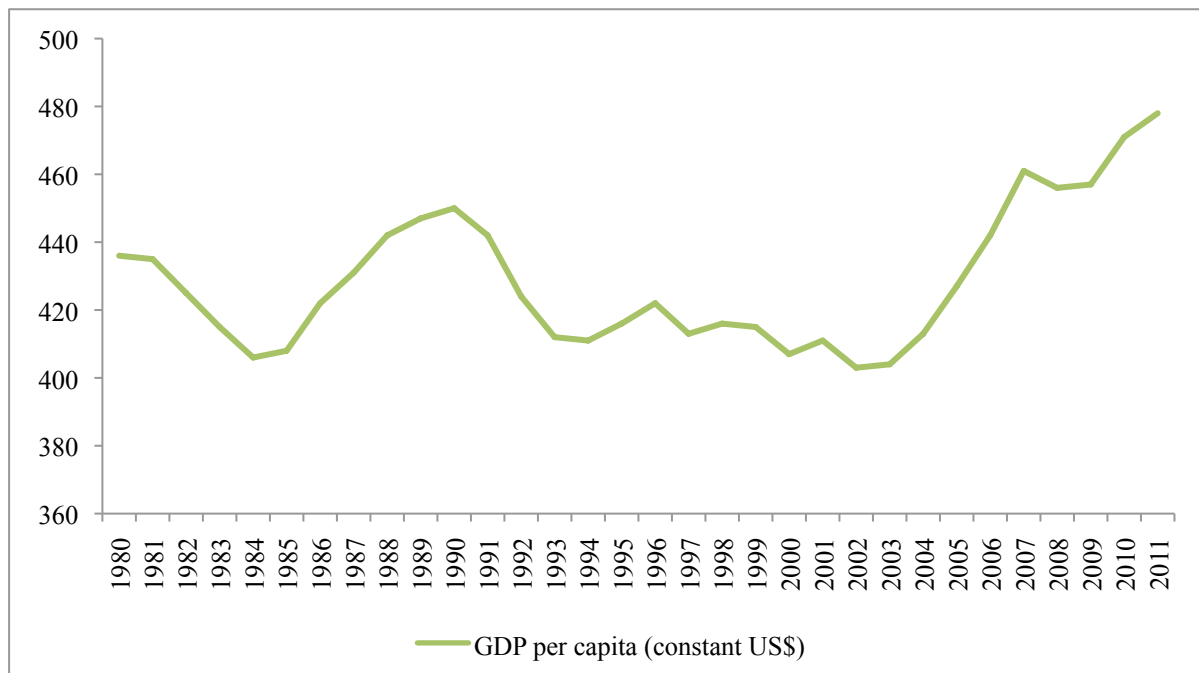
GDP growth (% annual), 1980–2011



Source: World Bank (2013a)

Figure 3.2.

GDP per capita (constant US\$)



Source: World Bank (2013a)

### 3.1.2 The EPZ Programme

Kenya's EPZ programme was initiated in 1990 as a tool in the export-led growth strategy.<sup>48</sup> The programme aims to attract export-oriented investments and achieve “job creation, diversification and expansion of exports, increase [...] productive investments, technology transfers and creation of backward linkages between the zones and the domestic economy” (KEPZA, 2013). The zone programme has a central role in the country's development plan, ‘Kenya Vision 2030’, which aims to develop, split, and distribute the existing EPZ and develop three additional zones in Mombasa, Kisumu, and Lamu. The zones are also to allow a wider range of commercial activity. The construction of the new zones is however behind schedule, and has yet not started.<sup>49</sup> The zones offer investors a number of tax benefits, among them a 10-year corporate tax holiday followed by a 25% tax rate, and incentives such as unrestricted repatriation of profit on capital and dividends from foreign exchange earnings, unrestricted foreign borrowing and capital, and exemption from certain licensing requirements. Additional incentives are listed in table A2 in the appendix.

Investments in the zones must be export-oriented within manufacturing, commercial activities, or export-related services, and domestic sales are restricted. The EPZ firms are in general to locate within the existing zones in Kenya, which are situated in Nairobi, Voi, Athi River, Kerio Valley, Mombasa, and Kilifi. The country had 47 zones in 2012, but about half are single firms, or EPU (see, e.g., McCormick, 2012). The largest zone is Athi River, one of two public zones controlled by the EPZ Authority. Athi River is situated 30 km from Nairobi in the Mavoko municipality; the EPZ is thus close to the capital of Kenya; the Jomo Kenyatta Airport, which is the largest airport in Eastern Africa; and the Nairobi–Mombasa railway (USITC, 2008). The Kipevu EPZ, the second public zone, is located close to Mombasa. The port of Mombasa is one of the busiest ports in Africa and also provides access by road and railway to Kenya's neighbouring countries.<sup>50</sup>

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<sup>48</sup> The EPZs were a part of an Export Development Programme. Other interventions in the Export Development Programme were manufacturing-under-bond, duty exemption, and VAT exemption schemes.

<sup>49</sup> The government of Kenya aim to transform the EPZ programme to a SEZ programme over time, and allow a wider range of commercial activities within the zones, and, among other goals, increase agro-processing, such as meat and fish processing and horticulture. The Kenya Vision plan aspires to transform Kenya into an industrialized middle-income economy by enhancing global competitiveness and increasing the diversity of industries. See Kenya Vision 2030 (2013) for more information.

<sup>50</sup> Most of the present zones are located close to Mombasa. The Kipevu EPZ did, however, remain largely undeveloped for an extended period after its establishment in 1996. In 2012 the zone was occupied by three enterprises linked to the textile and apparel sector. The Athi River EPZ had, by comparison, about 40 enterprises operating within the zone the same year (KEPZA, 2012).

Establishing infrastructure for the Athi River zone was estimated to cost about US\$30 million, or KSh2,536 million, to develop. The World Bank was to cover about 80% of the costs, and the Kenyan government the rest.<sup>51</sup> The Kenyan EPZ Authority (KEPZA) constructed most of the zone's industrial buildings that were built by 2005. Private contractors have since constructed a number of buildings for leasing within the zone, reducing the government's direct costs and hence the financial risk of the zone programme. The cost of establishing the Kipevu EPZ was estimated to cost US\$18 million. Funds were requested from the African Development Bank and the African Development Foundation (KEPZA, 2012; KEPZA, 2013).<sup>52</sup> Services within the zones are provided to tenants for a charge. The lease of the industrial buildings differs between the different zones from US\$2.00 per square foot per annum in Mombasa, US\$2.80 in Athi River, to US\$3.60 in Nairobi (KEPZA, 2013).<sup>53</sup> The government further charges the EPZs for services such as water utilities and electricity. The EPZ firm's expenditure on utilities such as power, water, and electricity is presented in table 3.4, and elaborated later in the thesis. Due to insufficient data on infrastructure costs it is difficult to assess the zones' full costs for the government.<sup>54</sup> The indirect costs, e.g., lost tax revenues from EPZ firms in Kenya, are furthermore especially difficult to assess due to a high number of EPU's and the difficulty in ascertaining if these are new investments.

## 3.2 The Success of Kenyan Zones

### 3.2.1 FDI and Export Diversity

Investments within the zones remained rather low and stagnant in the years prior to the establishment of the AGOA in 2000. In 1995 there were 12 zones. Investments within the zones were only KSh3.9 million, and zone output was negligible in terms of GDP (Mwenga & Ndung, 2001; Omolu, 2006). The number of enterprises and the level of investments increased considerably following the initiation of AGOA, mainly within the textile and

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<sup>51</sup> According to World Bank (1992), the Bank provided the Athi River project with US\$24 million based on estimated costs.

<sup>52</sup> Jauch (2002) estimates significantly higher costs for the Kenyan government to establish the zones, calculating the costs to be about 40 billion Kenyan shilling (KSh), or US\$514 million given the 2002 exchange rate.

<sup>53</sup> 1sq. m. = 10.76 sq. ft.

<sup>54</sup> According to Briceno-Garmendia and Shakaratan (2011) electricity in the country prior to 2008 was underpriced; water services may still be priced too low, causing a financial burden for the state.

apparel sectors. The exchange rate and the inflation rate were relatively stable in this period, which contributed to the increase in FDI (CBK, 2005). The number of firms within the textile and apparel industries increased from 10 to 40 in 2003 alone, and investments within the zones increased from KSh0.5 billion in 2000 to about KSh17 billion by 2004, as seen in table 3.1.<sup>55</sup> The increase in investments raised the amount of zone exports by 287% between 2001 and 2004, as seen in table 3.2. It is estimated that between 70 and 90% of zone exports were textile and apparel products to the US, aided by the AGOA. Kenya became and remains today one of the largest SSA exporters of textiles and apparel to the US (KEPZA, 2013; McCormick et al., 2006).

Table 3.1.

Number of zones and enterprises, and level of investments within Kenyan zones

Year	No. of zones	Enterprises	Investments (in million KSh)	Investments (in million KSh, adjusted for inflation)
1993	10	12		
1995	12			
1997	14			
1999	16	22	5,160	5,560
2000	19	24	6,107	6,218
2001	23	31	8,950	8,950
2002	31	54	12,728	12,602
2003	37	66	16,716	15,593
2004	41	74	17,012	14,805
2005	43	68	18,682	15,504
2006	39	71	20,320	15,642
2007	41	72	19,027	13,868
2008	38	77	21,701	13,974
2009	41	83	21,507	12,681
2010	42	75	23,563	13,620
2011	45	79	26,468	13,643
2012	47	82	38,535	18,040

Note: Inflation adjusted using GDP deflator (2001 = 100) from World Bank (2013a).

Sources: Mwenga and Ndung (2001); KNBS (2012–2013); ILO (1998); KEPZA (2003, 2005, 2008, 2012)

<sup>55</sup> See also Farole (2011), Chemengich (2010), and McCormick et al. (2004).

Table 3.2.

Exports, share of total exports, sales, and EPZ contribution to GDP, 1999–2012

	EPZ exports (in KSh millions)	Share of total exports (in %)	Total sales	EPZ contr. to GDP (in %)
1999	3,020		3,726	
2000	3,635		4,390	
2001	5,962		6,499	
2002	9,741	5.75	11,040	1.08
2003	13,818	7.54	14,817	1.40
2004	23,047	10.73	24,217	2.18
2005	20,036	7.69	23,774	2.03
2006	22,893	8.91	25,352	2.00
2007	27,408	9.98	29,400	2.2
2008	28,094	8.14	31,262	2.29
2009	23,948	6.94	26,798	1.92
2010	28,998	7.08	32,348	2.20
2011	39,067	7.64	42,442	2.76
2012	39,962	7.72	44,273	2.75

Sources: KEPZA (2005–2008); KNBS (2010–2012)

Following the end of the MFA in January 2005, the level of investment within the textile and apparel sector declined by 11.5%, from KSh8.6 billion in 2004 to KSh7.6 billion in 2008. By 2010 there were only 26 firms left within the textile sector (Chemengich, 2010; Farole, 2011). Investments within other sectors, including “horticulture and food processing, call centres, human and veterinary pharmaceuticals” did, however, see an increase causing investments within the zones to still grow in the period (Farole, 2011, p. 91).<sup>56</sup> Total sales from the EPZs also increased, despite a drop in exports in 2004–2005, as can be seen in table 3.2 and figure 3.3.<sup>57</sup> Production became increasingly more diverse and somewhat less concentrated in garment production. In 2008 the share of exports to the US had declined to 57.5% of EPZ output, though about 98% of US exports from the zones were still apparel

<sup>56</sup> KEPZA attempts to attract investments within food and agri-processing, such as fruit, fish, and meat processing; coffee and tea packaging; wood products; building materials; minerals; essential oils; and plant extraction. The authority also advocates investment opportunities within export services, such as Internet services, software development, web design, call centres, and research (KEPZA, 2013). Textile and apparel production is however still the most important sector within the zones.

<sup>57</sup> Farole (2011) finds the average growth rate between 2000 and 2008 to be 31% annually.

products (KEPZA, 2008; Farole, 2011).<sup>58</sup> Compared to a number of other African and non-African zone programmes the absolute levels of investment within zones in Kenya are low, but the zones did attract about 20% of foreign investments in the period from 2000 to 2008, according to Farole (2011).<sup>59</sup>

The post-election violence that occurred in 2008 had a detrimental effect on the manufacturing sector, through damage to supply chains and production, as it became difficult to obtain the necessary raw materials. Costs were also increased by halts in production and the need for extra security. The riots had visible effect on the economic growth rate and the country's GDP, as seen in figures 3.1 and 3.2. However, despite challenges in the global market, hard competition, uncertainties regarding the continuation of access to the US through AGOA, and the 2013 general election, investment levels and total sales within the zones have seen an increase in recent years.<sup>60</sup> Eighty-two firms operated within the zones in 2012 and total sales from the zones amounted to KSh44.3 billion. The value of exports notably exceeded the value of imports of the EPZ firms, as illustrated in figure 3.3. About a third of firms were textile and apparel producers or garment support services, which made up about half of total exports from the EPZs. Food- and agri-processing firms, have become more prominent over the years, producing about 18% of exports in 2012. In 2012, exports from the zones made up about 8% of total exports, as seen in table 3.2, and 4.25% of the manufacturing sector.<sup>61</sup> <sup>62</sup> Hence, it is evident that though the zones produce an important share of exports, EPZ production only makes up a small share of the manufacturing in the country. Despite growth in the EPZs, the manufacturing sector in the country has seen a decline in the growth rate in the period (KEPZA, 2012; KNBS, 2013). Domestic manufacturing firms in Kenya mainly sell goods on the domestic market and to Kenya's

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<sup>58</sup> Of the EPZ exports, 14.4% went to Europe, 14.1% to Asia, and 13.6% to other African countries mainly within COMESA and EAC (KEPZA, 2008).

<sup>59</sup> Ghana by comparison has US\$2.874 million invested within its EPZs and EPUs, Bangladesh US\$1.435, and the Dominican Republic US\$2.611, according to Farole (2011).

<sup>60</sup> Concerns about the rising levels of corruption in Kenya put its continued eligibility for AGOA benefits in jeopardy, as AGOA eligibility depends upon countries meeting human rights and governance requirements. Exports from Kenya that were eligible for AGOA benefits had a value of US\$380 million in 2012, whereas US\$262 million were produced within the EPZs (Liloba, 2013). Madagascar is, as an example, currently suspended from being an AGOA beneficiary due to the political crisis in the country that started in 2009 (AGOA info, 2013).

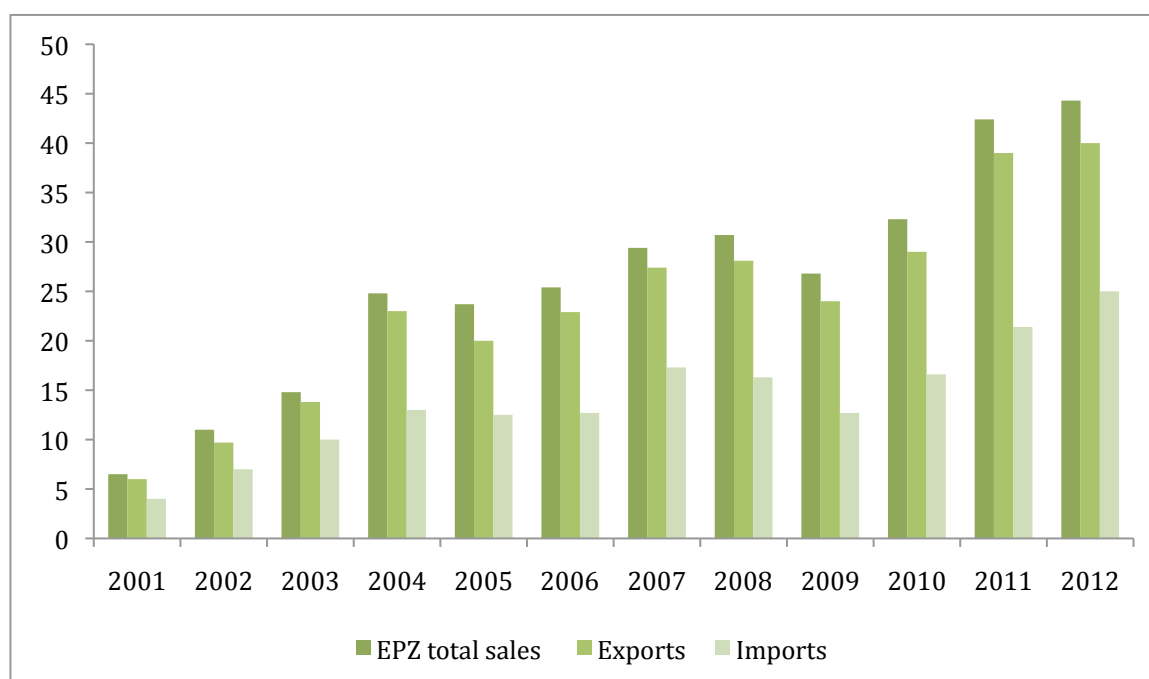
<sup>61</sup> According to Boyenge (2007) and Kingombe and Te Velde (2013), exports from the Kenyan zones made up 80% of total merchandise exports in 2002 and 86.9% of national exports in 2006. Farole (2011) finds that exports from the zones made up 9% of non-oil exports and 25% of manufacturing exports in 2008.

<sup>62</sup> Total apparel and textile exports, from the zones and the overall economy, constitute the fourth-largest exported merchandise commodity, after tea, horticulture, and coffee.

neighbouring countries (see, e.g., Clarke, 2012). Moreover, though total exports have seen an increase, the growth in imports has been causing an increase in the trade deficit of goods and services over the period (KNBS, 2005, 2008, 2012; World Bank, 2013a).

Figure 3.3.

EPZs firms' total sales, imports and exports



Source: KEPZA (2003–2012)

The shares of value added from agriculture and manufacturing have been relatively stable over the period from 1980, as figure 3.4 shows. The export structure according to the different sectors, and the destination of exports, have both also only changed a little from 1995, though exports to other African countries have become more important (see figures 3.5 and 3.6). Kingombe and Te Velde (2013) do find however that the use of zone programmes has contributed to some change in the export structure in Kenya, even though the change is limited relative to other countries, such as Mauritius, the Dominican Republic, Malaysia, and Costa Rica. The African Economic Outlook (AEO) (2012a) concludes that to some extent Kenya has seen an economic transformation of its economy. Kenya has yet, however, to see a sizeable change from low-value added production to higher-value production, according to the IMF (2010).

Figure 3.4.

Manufacturing and agriculture as share of GDP, 1980–2011

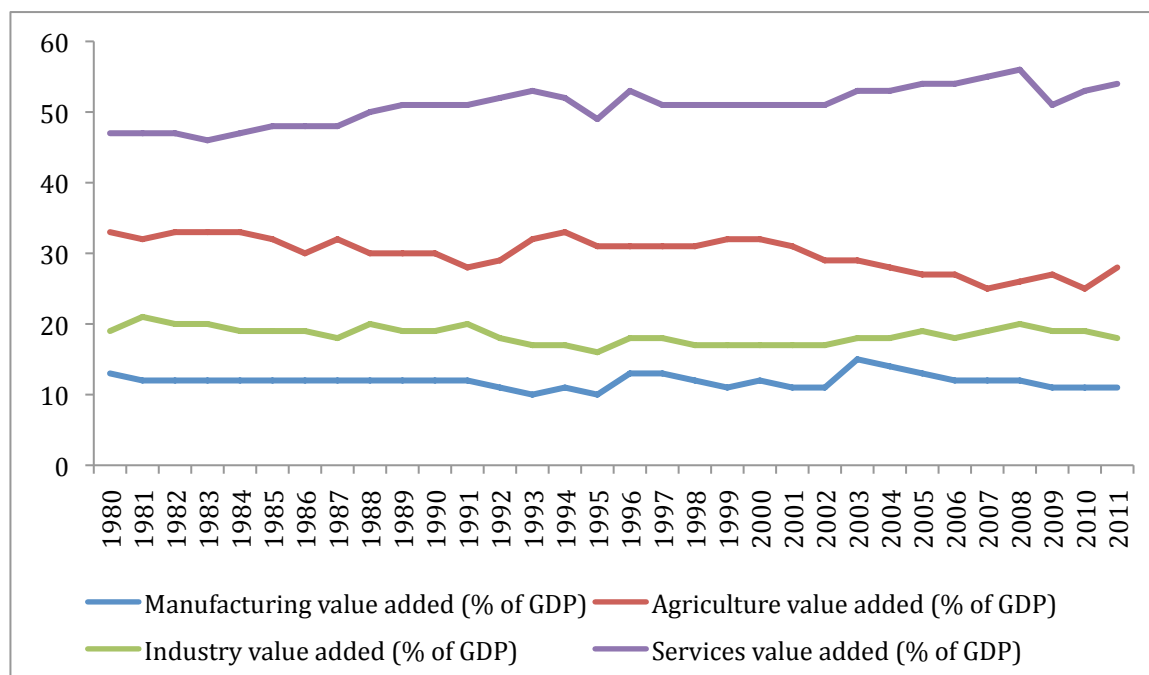
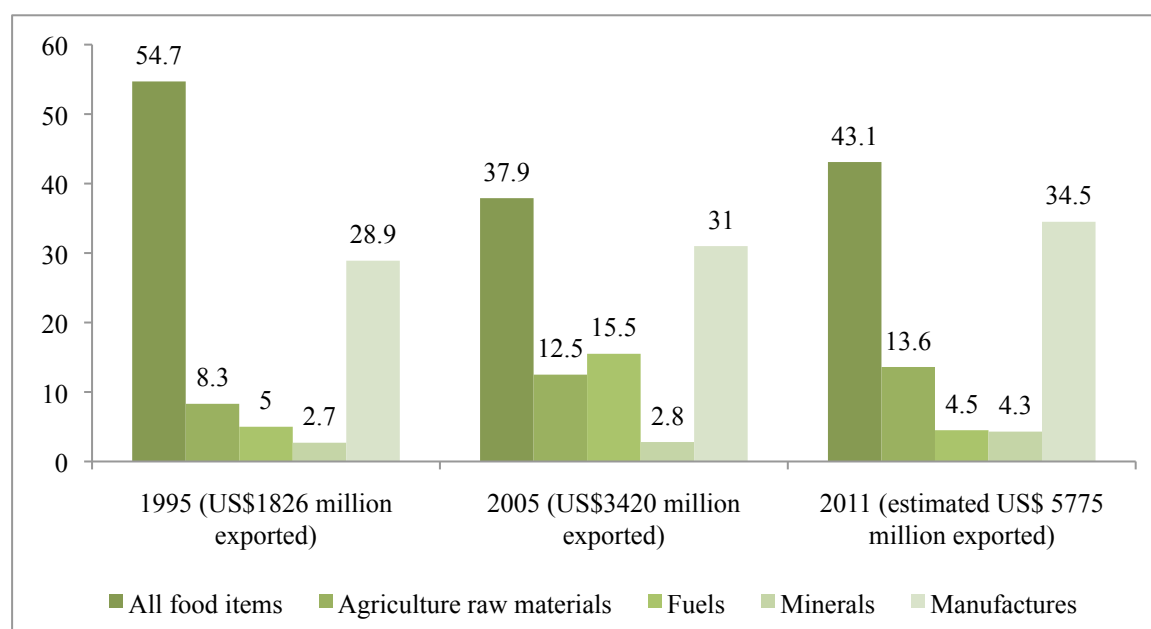
Source: World Bank (2013a)<sup>63</sup>

Figure 3.5.

Exports structure (in %)



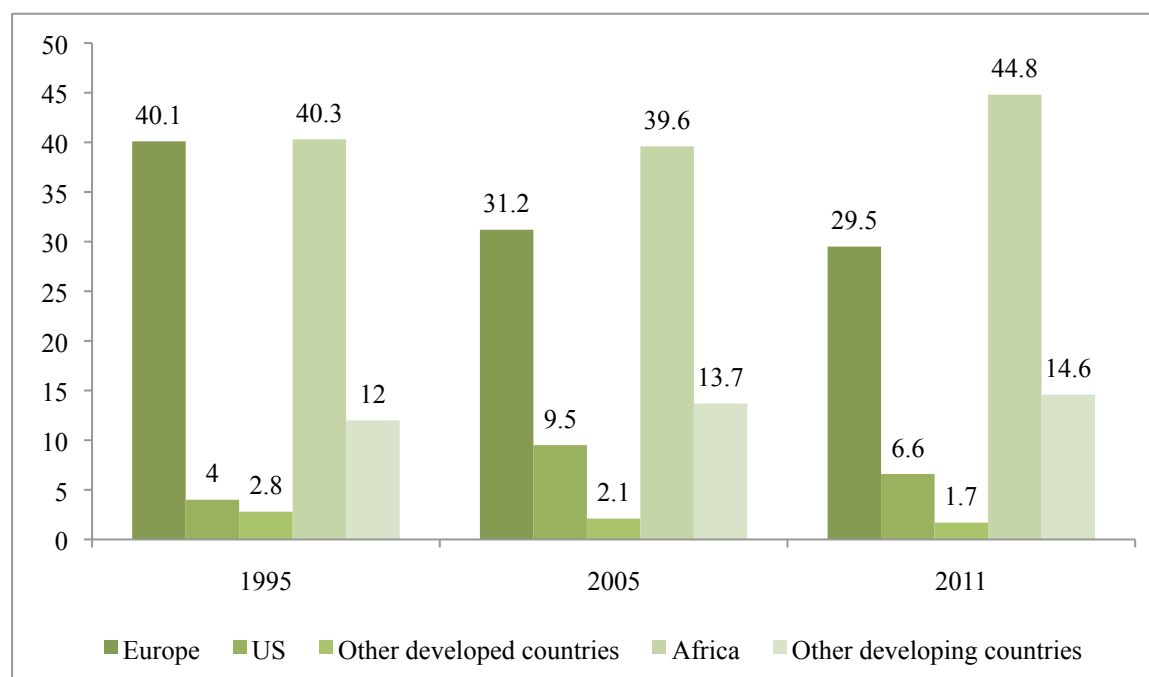
Source: UNCTAD (2012b)

<sup>63</sup> ‘Value added’ is defined as “the net output of a sector after adding up all the outputs and subtracting intermediate inputs” (World Bank, 2013a). Industry here includes manufacturing, mining, construction, electricity, water and gas. Services include wholesale and retail trade, transport, government, financial, professional, and personal services (education, health care, and real estate services).



Figure 3.6.

Exports structure by destination (in %)



Source: UNCTAD (2012b)

### 3.2.2 Employment within the EPZs

Kenya has a high unemployment rate, especially among youth, and employment and income creation are important targets for the EPZ programme, and in the country's development plan.<sup>64</sup> Direct employment within the textile and apparel sector rose from 10,000 prior to the initiation of AGOA, to 36,600 in 2005. Total employment within the zones was about 39,000 in 2005, see table 3.3. It is further estimated that about three times the number of employees benefited from the textile value chain and from complementary services through indirect employment (see, e.g., Chemengich, 2010; Omolu, 2006). The textile and apparel sector accounted for about 90% of employment within the country's zones in 2005 (Collier & Venables, 2007). The end of the MFA had a significant impact on employment in the textile and apparel industry, and though employment within nonapparel industry increased, total employment within the zones declined to 30,000 in 2008 (see table 3.3). Because women make up the majority of the workers in the textile and apparel industry, most of those who lost their jobs were women, often with few other opportunities for employment and income (see, e.g., Chemengich, 2010).

<sup>64</sup> Youth unemployment constitutes 70% of total unemployment according to the AEO (2012a), and the share is increasing as new workers enter the workforce.

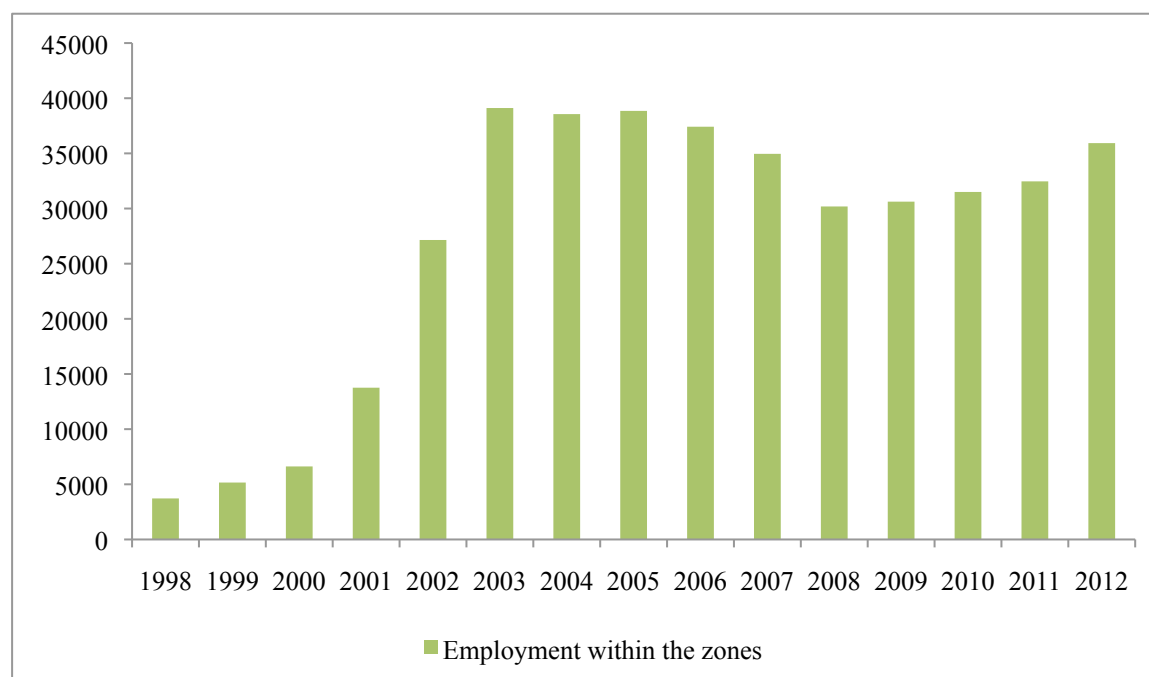
Table 3.3.  
Employment within Kenyan zones

Year	Employment of Kenyans	Employment of foreigners	Total employment	% of manuf. Employment	% of total employment
1993	1,594			0.84	
1998	3,645	74	3,719		
1999	7,077	83	5,160		
2000	6,487	133	6,620		
2001	13,444	314	13,758		
2002	26,447	701	27,148	11.5	0.38
2003	38,199	912	39,111	15.93	0.52
2004	37,723	837	38,560	15.58	0.48
2005	38,051	800	38,851	15.37	0.46
2006	36,757	649	37,416	14.49	0.43
2007	34,446	511	34,957	13.38	0.37
2008	30,187	471	30,658	11.43	0.30
2009	30,115	508	30,623	11.54	0.29
2010	31,026	476	31,502	11.75	0.29
2011	32,043	421	32,464	11.80	0.28
2012	35,501	428	35,929	12.77	0.28

Sources: Rolfe et al. (2004); KEPZA (2005–2012); CBK (2012)

Figure 3.7.

## Total employment within the zones



Source: Data from table 3.2

In its 2007 strategic plan, the Export Processing Zone Authority in Kenya (KEPZA) set a goal of more than doubling employment within the zones by 2013, by targeting sectors with both high employment potential and high-quality jobs (KEPZA, 2007; Omondi, 2010).<sup>65</sup> However, a notable increase in employment has yet to take place due to a decline in the textile and apparel sector, and an increase in industries that are less labour-intensive, and hence have created little employment. The textile and apparel sector still accounted for about 80% of jobs within the zones in 2012, though less than a third of EPZ firms are within the sector. Only 11% of EPZ workers were employed within the agri-processing sector (KEPZA, 2012). About 3,500 jobs were created within the zones during 2011. Employment within the zones was however still lower than at the peak of 2004, when it rose to about 36,000 in 2012, as can be seen in table 3.3 and in figure 3.7. EPZ employment makes up 12.8% of manufacturing employment, which is notable given the smaller share of manufacturing production, but its share of national employment is marginal. The informal sector, called '*Jua Kali*', remains the main source of employment generation.<sup>66</sup> For this reason, employment within the informal

<sup>65</sup> Employment generation within the zones is also an essential part in the country's development plan and in the poverty reduction plan prepared by the IMF.

<sup>66</sup> The informal sector constituted 80.8% of all employment in 2011 (KNBS, 2012).

sector has seen a greater increase compared to employment within the formal sector (KNBS, 2012).

### **3.2.3 Training Facilities and Knowledge and Technology Spillovers**

KEPZA aims to enhance skill development and technology transfers by implementing training- and skills-transfer programmes. Forty-one EPZ firms provided some type of training to their local employees in 2008. Training was also given at the management level, though this is limited and working permits are given to foreigners with special skills in management, as well as technology (KEPZA, 2008; KEPZA, 2013). Farole (2011) finds about a third of management positions to be held by foreigners, a relatively high share compared to many other zones, suggesting that management training is relatively low in Kenya. The high share of foreign management may also imply that foreign-owned firms are relatively footloose. KEPZA does not provide data on the number of unskilled and skilled workers within the zones, making further analysis of EPZs' use of skilled workers and the effect of training infeasible.

Five of seven public universities in Kenya offer courses related to the textile and apparel sector, within design, engineering, and technology, as well as business studies (see, e.g., Nguku (2012)). The National Industrial Training Authority (NITA) has five training centres, with one each in Athi River, Kisumu, and Mombasa, and two in Nairobi. The centres offer training within a range of different sectors, including mechanical, electrical, electronics, automotive, textile and apparels, and information communication technology (ICT) (NITA, 2013; Nguku, 2012). The IMF (2010) argues that training facilities are inadequate and linkages between the facilities and industries are poor, causing disparities between the technical skills available and the demands of the industries. The use of new technology, innovation, and research and development facilities within Kenya furthermore remains low.

Knowledge spillovers from the EPZ firms are expected by KEPZA through labour circulation, among other means. According to Kimuya (2005) and the World Bank (2005), by 2005 most EPZ firms in Kenya had few linkages with local firms and thus little possible impact on productivity. Farole (2011), however, finds evidence of labour circulation between zone-based and local firms, and argues that this implies possibilities for the transfer of skills and knowledge. According to Kingombe and Te Velde (2013), the zones in Kenya have contributed to increasing labour productivity in manufacturing by between 16% and 29% in the period between 1990 and 2007, or between 1.5% and 2.5% annually. Moreover, according to USITC (2008), joint ventures within the textile industry have enabled domestic producers

to secure technology that allowed them to expand operations in Kenya. Studies also find evidence of increased productivity levels within the zones due to a change in production and the competitive pressure on EPZ firms from Asian producers to increase volume per worker (Farole 2011; Kingombe & Te Velde (2013).

### 3.2.4 Backward Linkages

Import substitution policies made the textile and apparel sector one of the largest manufacturing sectors.<sup>67</sup> However, the change to export-led growth in the 1990s, a high inflow of used clothes, and reduced domestic demand significantly reduced textile production and halved the capacity utilization of the mills (KEPZA, 2005b). In 2005 there were 35 textile mills serving textile and apparel firms, and cotton production engaged 140,000 small-scale cotton farmers, down from 200,000 at the peak in the mid-1980s. Only a fraction of suitable land was used for cotton production, suggesting good possibilities to enhance production. Food security is, however, a growing problem in Kenya due to large fluctuations in water supply and high population growth (KEPZA, 2005b; IFPRI, 2013).<sup>68</sup> Mills in Kenya struggle to be able to produce good-quality yarn and fabrics competitive with Asian countries; yarn and fabrics are primarily imported from lower-priced Asian countries, such as India, Bangladesh, China, and Malaysia (Kingombe & Te Velde, 2013; Farole, 2011). According to data from Farole (2011) the textile and apparel industry only sourced 17% of inputs locally in 2008. The food and agri-processing sector had a considerably higher use of local inputs, as seen in figure 3.8. The textile and garment sector is still the largest consumer of local goods, due to its size (KEPZA, 2012).<sup>69</sup> The government is aiming to increase investments in mills to increase African-sourced fabric, and to improve the quality and variety of Kenyan textiles. This is important to be able to meet AGOA requirements regarding the source of inputs for AGOA-eligible products (KEPZA, 2007; KEPZA, 2013). The insecurity related to the continued market access through AGOA has, as pointed out by Kingombe and Te Velde (2013), a significant negative impact on investments within the textile and apparel sector, as

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<sup>67</sup> The government imposed a 100% import duty on textile and apparel imports since independence in 1963 until the 1990s, and encouraged backward linkages from the sector through textile mills sourcing cotton from small-scale producers (KEPZA, 2005b).

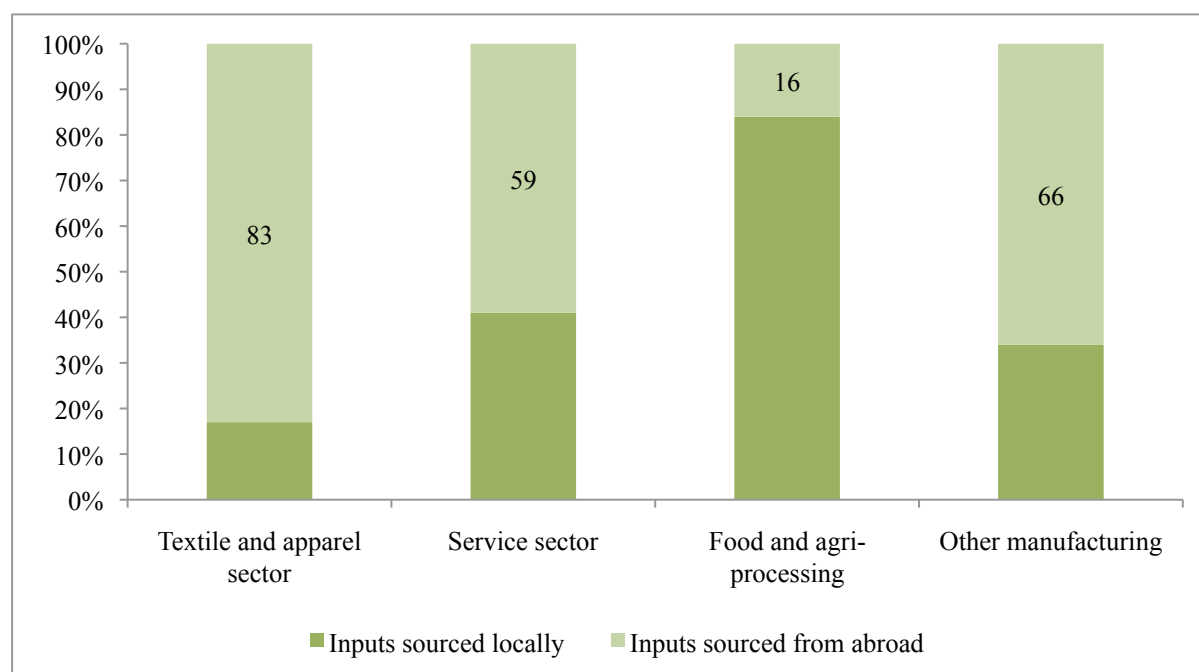
<sup>68</sup> It is estimated that Kenya had 350,000 hectares of land suitable for cotton production, but only about 25,000 hectares were used for this purpose in 2003 (KEPZA, 2005b).

<sup>69</sup> The textile and apparel sector made up 30.6% of EPZ expenditure on local goods in 2012 (KEPZA, 2012).

Kenya was unlikely to have been eligible if the third-country fabric provision had not been extended.<sup>70</sup>

Figure 3.8.

Average use of local inputs in the different sectors within the zones in 2008 (in %)



Source: Farole (2011)

Total domestic expenditures on local inputs, utilities, salaries, and other expenditures by EPZ firms, and hence inflow of foreign exchange, have been increasing with the number of firms and investments and the change in sectors, from KSh2.2 billion in 2002 to KSh18.1 billion in 2012, as shown in tables 3.4 and 3.5. The increase in domestic expenditures is, however, not as impressive if adjusted for inflation, as shown in figure 3.9. KEPZA aims to significantly increase domestic expenditures by encouraging greater backward linkages with a subsequent positive effect on indirect employment and possible spillovers. The aim was to be met by increasing the focus on sectors that use higher shares of local inputs (KEPZA, 2007). EPZ firms' purchases of local raw and intermediate goods for production, and EPZ workers' consumption have contributed to somewhat increase economic activity and growth in the areas surrounding the EPZs, according to KEPZA (2012). More precise measures of the effect

<sup>70</sup> The extension up to 2019 is contingent on there being a successful conclusion of the WTO Doha Development Agenda Round of Negotiations before the end of 2015. See further information about AGOA in the appendix.

are however not available, which makes it difficult to estimate the value of demand linkages beyond total local expenditure by the EPZ firms.

Table 3.4.  
Expenditures on utilities by EPZ firms, in KSh millions

<b>Year</b>	<b>Power</b>	<b>Telecommunication</b>	<b>Water</b>
2001	112	54	17
2002	147	73	24
2003	258	82	61
2004	302	105	72
2005	366	112	84
2006	522	117	121
2007	421	114	75
2008	575	88	55
2009	488	90	58
2010	522	135	71
2011	701	61	87
2012	757	66	117

Source: KEPZA (2005a, 2008, 2012)

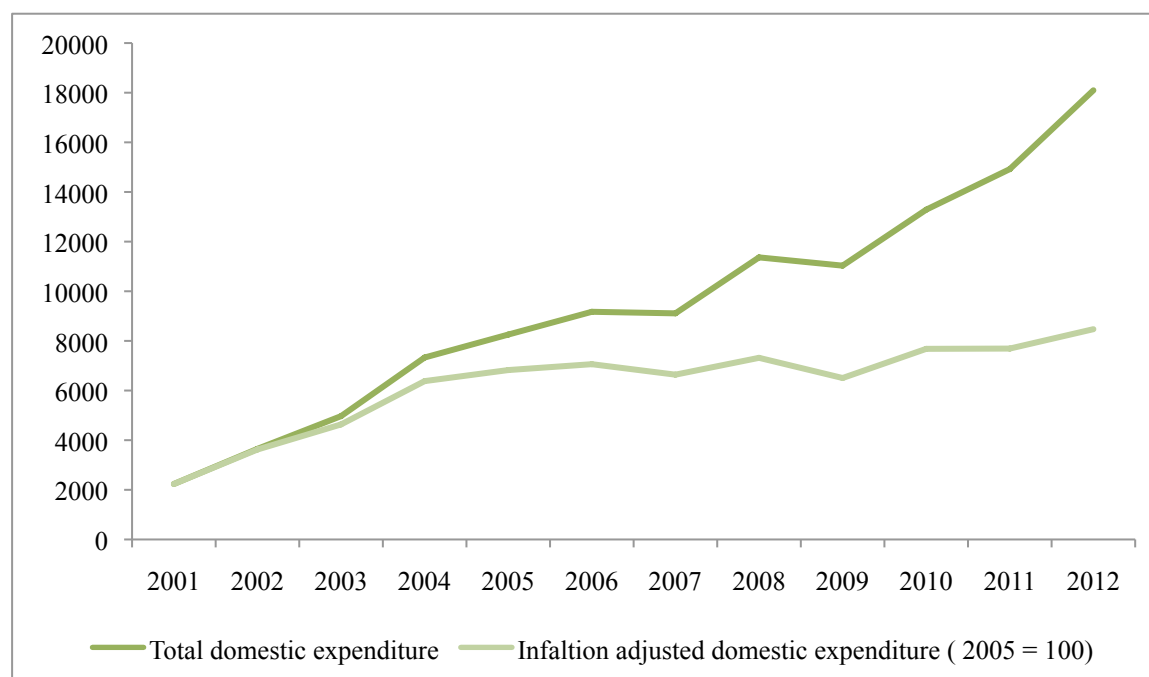
Table 3.5.  
Local purchases, local salaries, other expenditures, and total domestic expenditures

<b>Year</b>	<b>Local purchases</b>	<b>Local salaries</b>	<b>Other domestic expenditure</b>	<b>Total domestic expenditure</b>
2001	718	832	502	2,235
2002	1,127	1,582	698	3,651
2003	1,176	2,398	994	4,969
2004	1,893	3,258	1,701	7,331
2005	2,388	3,017	2,288	8,255
2006	3,253	3,299	1,861	9,173
2007	3,454	3,197	1,289	9,110
2008	4,476	3,044	3,127	11,365
2009	3,942	3,274	3,180	11,032
2010	4,661	3,585	4,315	13,287
2011	6,276	3,769	4,024	14,921
2012	8,027	4,509	4,619	18,097

Source: KEPZA (2005a, 2008)

Figure 3.9.

Total domestic expenditures by EPZ firms (2001–2012)



Note: Inflation adjusted using GDP deflator (2001 = 100) from World Bank (2013a).  
Source: KEPZA (2003, 2008, 2012)

### 3.3 Kenyan Investment Environment

#### 3.3.1 Political and Macroeconomic Stability and Overall Competitiveness

Kenya has generally been politically stable since independence in 1963. However, there have been episodes, such as the post-election crisis of 2007, with detrimental effects on investments. The country has also experienced a number of terrorist attacks, the latest in 2013, which is expected to some extent have a negative impact on tourism and foreign investment, and subsequently economic growth, among other things (“Kenya: A murky aftermath”, 2013).<sup>71</sup> Volatile inflation and exchange rate fluctuations have had an effect on macroeconomic stability and investments. Price stability is yet an important target for the government. The poor economic performance of the early 1990s was linked to steep inflation, as seen in figure 3.10. Figure 3.11 shows that the exchange rate has seen an almost continual

<sup>71</sup> The president and the vice-president moreover currently face charges by the International Criminal Court (ICC) for contributing to the violence in 2007–2008 (“Kenya: A murky aftermath”, 2013).



depreciation since 1980. The figure only compares KSh to US dollars, and does not take differences in inflation into account.<sup>72</sup>

In 2012 Kenya ranked 109 of 185 countries in the ease-of-doing-business index from 2012, which, while not a good ranking, meant it was still among the top ten countries in Africa.<sup>73</sup> By comparison, Mauritius was ranked number 23 and South Africa number 35.<sup>74</sup> In 2013, Kenya's ranking dropped to number 121 of 185. Hence, the obstacles to business in the overall economy increased relative to other countries (IFC, 2012, 2013). Corruption is one of the great obstacles the overall business environment faces.<sup>75</sup> The World Economic Forum (WEF) (2013) ranks Kenya as number 106 out of 144 countries according to its global competitiveness index (GCI), as determined by the level of productivity.<sup>76</sup> This is a better ranking than many other African countries, as with the cost-of-doing-business index. However, also according to the GCI, Kenya's competitiveness has declined relative to other countries<sup>77</sup> Improvements in factors determining competitiveness are needed, and increased competitiveness is an important target in the country's development plan, where the zones have a central plan, as mentioned above.

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<sup>72</sup> Data from the World Bank do not include the real exchange rate for Kenya this period.

<sup>73</sup> The index ranks countries from 1 to 185, depending on the ease of "starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency" (IFC, 2013, p. 2). Most SSA countries can be found close to the bottom of the list.

<sup>74</sup> Kenya is ranked, together with South Africa and Mauritius, as a low-risk country to invest in by the professional service company Ernst and Young (Ernst & Young, 2012).

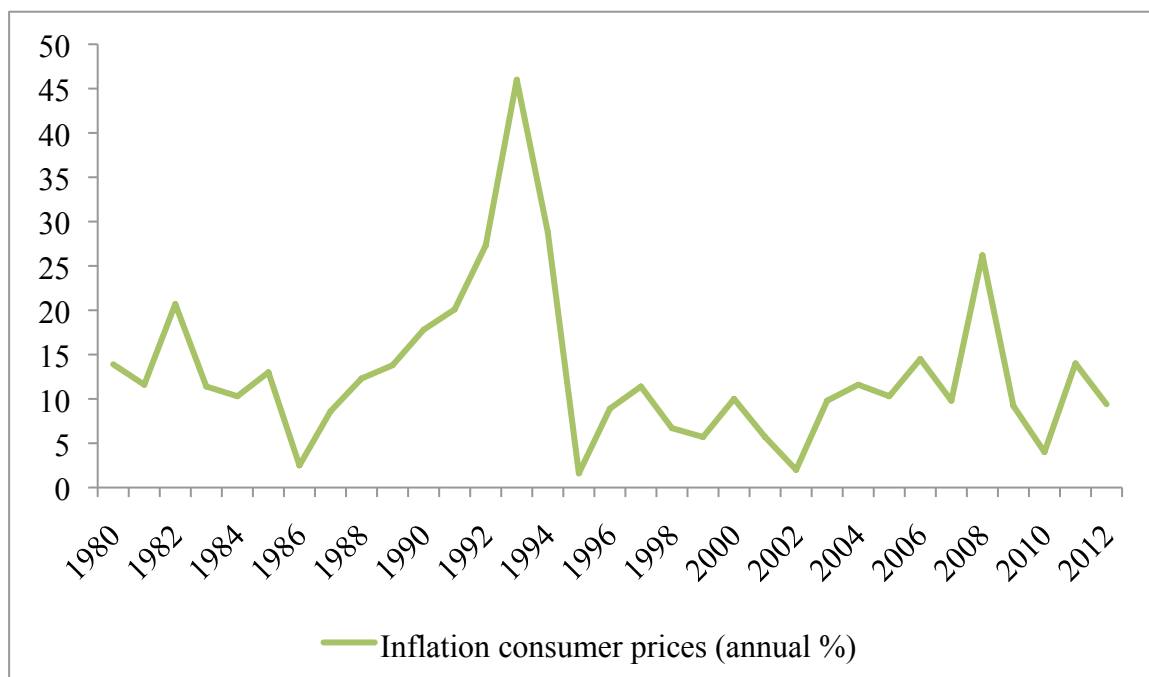
<sup>75</sup> In a survey conducted by the World Bank in 2007, 38.3% of private firms in Kenya identified corruption as a major constraint to business. Table A3 in the appendix summarizes the findings of that survey, and compares the findings to SSA and low-income countries.

<sup>76</sup> WEF (2013, p. 4) defines competitiveness "as a set of institutions, policies, and factors that determine the level of productivity of a country".

<sup>77</sup> The GCI for Kenya has declined from 3.81 to 3.75 in the period. The GCI ranges from 1 to 7. Kenya had a ranking of 93 in 2008, though more countries have entered the study (WEF, 2009, 2013)

Figure 3.10.

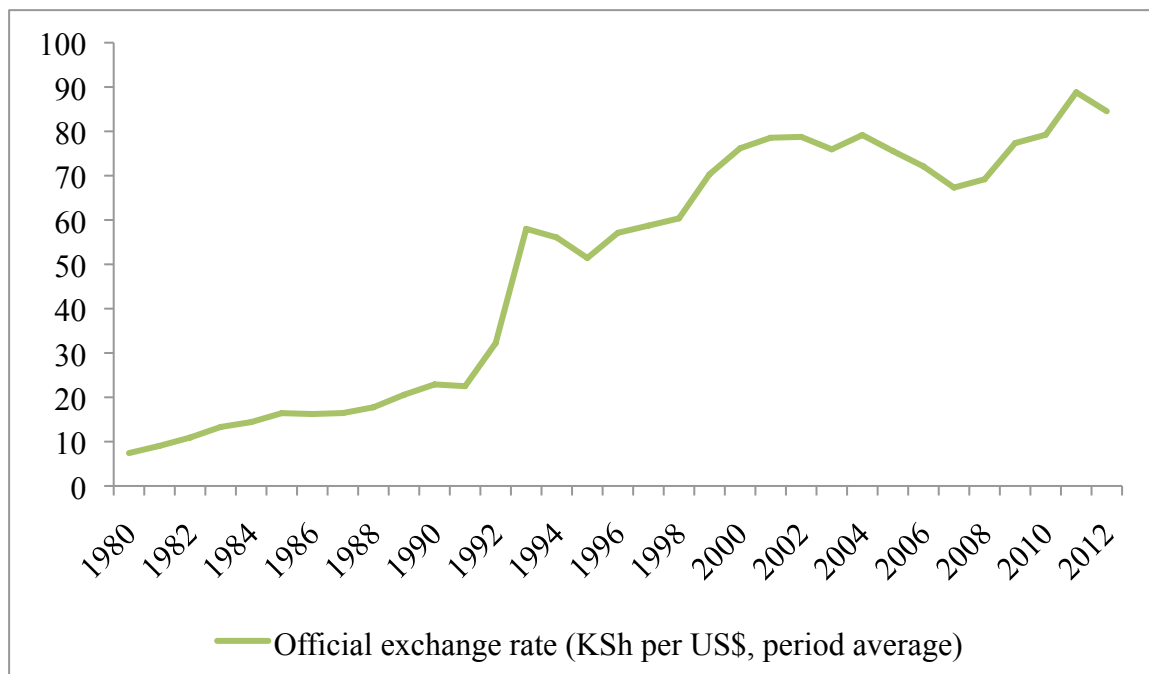
Inflation in consumer prices (annual %)



Source: World Bank (2013a)

Figure 3.11.

Official exchange rate (KSh per US\$, period average)



Source: World Bank (2013a)

### 3.3.2 Infrastructure

The infrastructure in Kenya is seen as adequate to attract investors to SEZs, and relatively better than many other African countries.<sup>78</sup> KEPZA does, however, recognise that the zones are still negatively affected by low-quality infrastructure, such as poor transportation systems, high costs of electricity, unreliable water supply, inefficient administration, and a low level of business facilitation. These challenges increase the cost of doing business within the zones as well as within the domestic economy, reducing the competitiveness of Kenyan industries. KEPZA aims to minimize bureaucracy and administrative procedures and promises rapid project approval, a one-stop shop for investor support, and an on-site customs office (KEPZA, 2013). However, according to Farole (2011) and WEF (2013) Kenya has yet to implement an efficient one-stop shop that benefits zone investors.<sup>79</sup>

Kenya has relatively good connections to international markets, through the port in Mombasa and three international airports. Nairobi is the key transportation centre for eastern and central Africa, and the largest African city between Cairo and Johannesburg.<sup>80</sup> In terms of handling capacity, the port of Mombasa is the fifth-largest port in Africa. The port saw an increase of 145% in goods handled between 2006 and 2010 (IMF, 2012b). Efficiency measures at the port are, however, relatively poor, and both the capacity and the efficiency of the port need to be improved, requiring substantial investments (CBK, 2004).<sup>81</sup> The road and rail networks connecting to the port are also in need of upgrading. Transport within the country is furthermore perceived as a major obstacle to business by private firms (World Bank, 2007).<sup>82</sup> Development of road and rail infrastructure is one of the key areas of focus in a 2010 poverty strategy report by the IMF.<sup>83</sup>

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<sup>78</sup> See, e.g., Rolfe et al. (2004) and KEPZA (2007). According to a survey, investor satisfaction was 60% within the zones in 2007 (KEPZA, 2008).

<sup>79</sup> According to the WEF (2013), 11 procedures were required to start a business in Kenya.

<sup>80</sup> Kenya does however lack direct flights to the US, the main importer of the apparel and textiles from the zones, increasing transport costs and reducing the country's competitiveness (Chemengich, 2010).

<sup>81</sup> According to the 2012 Global Competitiveness report by the WEF, the quality of ports in Kenya got a score of 3.8 out of 7. The average of all countries included in the survey was 4.3.

<sup>82</sup> See table A3 in the appendix for further findings.

<sup>83</sup> The World Bank, the EU, and the Nordic Development Fund are among the organisations that have contributed significant funds to carry out improvements to road infrastructure in the country.

Another obstacle to business is unreliable and expensive electricity.<sup>84</sup> Electricity in Kenya has been relatively expensive compared to both Asian countries and other African countries as Egypt and South Africa (CBK, 2004; Chemengich, 2010; KEPZA, 2012).<sup>85</sup> High prices and unreliable supply in Kenya has resulted in about 70% of firms owning their own generators. The government has also at times urged manufacturing firms to move to night production to reduce the strain on power capacity during the day (IMF, 2010; Brinceno-Garmendia & Shakaratan, 2011). Kenya has however managed to significantly improve electricity supply and shorten the waiting time for electricity connections within the zones, making the zones now globally competitive in terms of electricity (Farole, 2011). Electric capacity has seen a continuous increase, but it still has not been sufficient to meet the increase in demand; only 16.1% of the population had access to electricity in 2009 (CBK, 2010; World Bank, 2013a). According to Brinceno-Garmendia and Shakaratan (2011), there is an acute need to double the capacity to produce power during the next decade.<sup>86</sup> Hydropower provides the largest source of electricity, and large fluctuations in rainfall cause volatility in supply and uncertainty regarding both electricity and water supplies.<sup>87</sup> Kenya is mainly dependent on surface water, and unreliable water supply and poor water utilities have a negative effect on investment, though water utilities are relatively more efficient than in other low-income countries, including Kenya's neighbouring countries (Brinceno-Garmendia & Shakaratan, 2011; IMF, 2010). The costs of ICT services were in 2010 much higher in Kenya than in Asian countries, but EPZ firms' expenditures on telecommunication have seen a noteworthy decline since 2010 due to a reduction in prices, as seen in figure 3.4 above (IMF, 2010; USITC, 2008).

Today about half of the zones are concentrated in proximity to Mombasa. The government aims to increase the number of zones, in part by splitting existing zones, and evenly distribute the zones between the regions, with the goal of having at the minimum two zones in each province. The increase in the number of zones is intended to improve regional development and reduce rural-urban inequality (KEPZA, 2007; KEPZA, 2012). Significant

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<sup>84</sup> The quality of the electricity supply in the country got a value of 3.6 by WEF (2012), where 1 is insufficient and suffers frequent interruptions, and 7 sufficient and reliable.

<sup>85</sup> The price of electricity in 2004 was US\$.80, compared to US\$.20 and US\$.27 in Egypt and South Africa, respectively (CBK, 2004).

<sup>86</sup> Electricity generated from geothermal and thermal sources has increasingly reduced the share of electricity produced from hydropower. The share of hydropower declined from 67% to 38.8% of all electricity from 2004 to 2010 (CBK, 2004; CBK, 2010).

<sup>87</sup> Large variations in water supply also affect agricultural production and have a subsequent effect on economic growth. See, e.g., AEO (2012a).

improvements in overall infrastructure are required to facilitate this. The country's population, agriculture, and infrastructure are today concentrated in the south, from Mombasa, to Uganda, through Nairobi and Kisumu. The north has a low population density and poor infrastructure (Briceno-Garmendia & Shakaratan, 2011).

### 3.3.3 Domestic Sales and Domestic Investments

Kenya is an attractive entry point to the East African region, and investors within the zones have been and are from a variety of locations, such as East Asia, South Asia, Europe, and the US (Farole, 2011). The Kenya Investment Authority (KenInvest) and KEPZA encourage investments targeting the regional market and promise access to these markets for investors through Kenya's membership in the Common Market for Eastern and Southern Africa (COMESA).<sup>88</sup> The East African Community (EAC) customs union does, however, restrict EPZs sales to the region, as member countries are considered part of the domestic market under the agreement. EPZ firms are only allowed to sell up to 20% of manufactures and services to the domestic market, and these sales are treated as imports from non-COMESA countries and subject to VAT and import duties (KEPZA, 2013).<sup>89</sup> The enlargement of the domestic market in 2010 to include the EAC region has according to Omondi (2013) caused inland zones to be less popular for investors relative to the zones close to the port of Mombasa, where access to export markets is easier.<sup>90</sup> This challenges the government's vision to spread out the zones, and is one of the current challenges facing EPZ firms and the EPZ programme. A number of firms have been required to shift their focus from regional to global markets (KEPZA, 2012). The level of domestic sales has, however, been significantly lower than 20% for most years, including after 2010, although relatively high in 2005, according to data from KEPZA, as figure 3.7 shows. This suggests that the domestic market is either not an attractive target for existing investors or that the obstacles for domestic sales are too extensive. Fewer restrictions on sales within the EAC may enable Kenya to increasingly attract greater investments, as the region grows.<sup>91</sup> Local domestic firms are

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<sup>88</sup> Member states in COMESA are Burundi, Comoros, the Democratic Republic of the Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Libya, Madagascar, Mauritius, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia, and Zimbabwe.

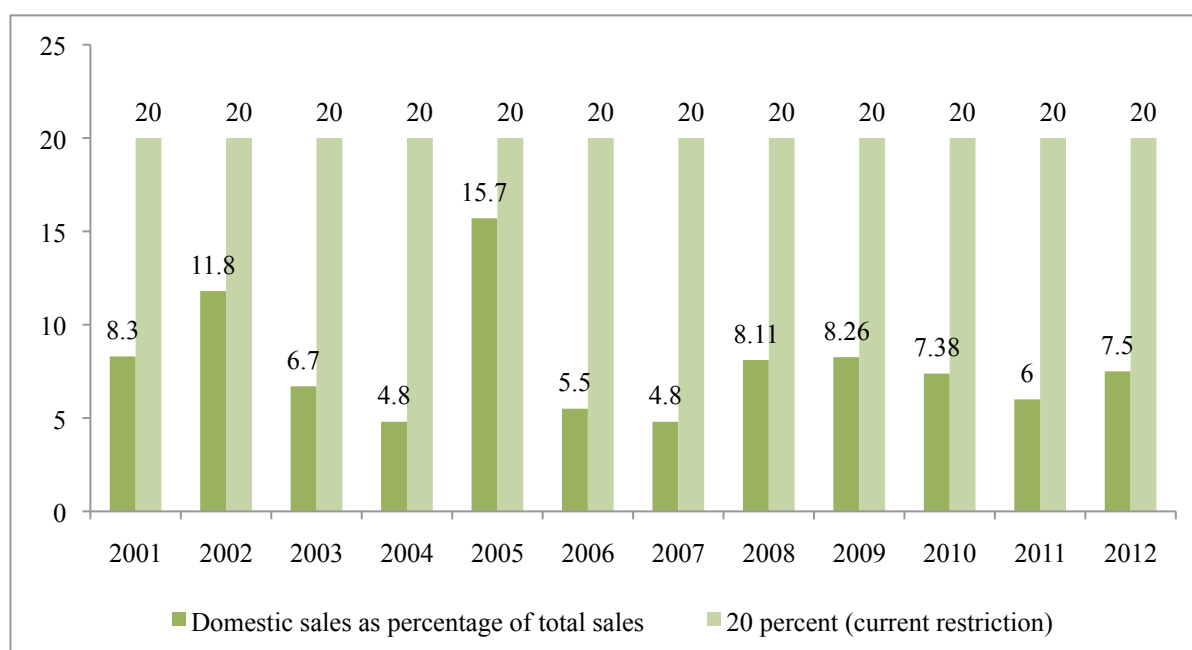
<sup>90</sup> EAC consists of Kenya and its neighbouring countries: Burundi, Rwanda, Tanzania, and Uganda. EAC became a customs union and adopted common external tariffs on 1 January 2010 (EAC, 2013).

<sup>91</sup> The EAC region constitutes a potentially great opportunity for investors with more than 130 million people in 2010 (EAC, 2013).

however opposed to allowing EPZ firms better access to the domestic market, as they fear it the effect of an increase in competition (Omondi, 2010). Manufacturing firms in Kenya mainly sell their goods on the local market or to Kenya's neighbouring countries. This suggests that they are not competitive with EPZ firms exporting to developed markets, such as Europe and the US (see e.g., Clarke, 2012).<sup>92</sup>

Figure 3.12.

Domestic sales as a share of total sales, 2001–2012



Source: KEPZA (2005a, 2008)

According to Odhiambo (2008), Kenya has one of the most developed financial systems in SSA, yet 41.8% of respondents in the World Bank's (2007) enterprise survey identify access to finance as a major constraint to business. Locally owned investments within the zones were 17% in 2007, and KEPZA aimed to nearly double that amount by 2013 in the strategy plan of 2007.<sup>93</sup> Local small and medium companies with high growth and potential to become full-time exporters have been targeted, through the Export Business Accelerator Programme. Firms have been chosen from targeted sectors, such as horticulture, commercial crafts, apparels and textiles, and ICT. The government also encourages joint venture

<sup>92</sup> Manufacturing firms in Kenya export rather high shares of sales, which could suggest that the firms are relative competitive. However, exports are mainly to neighbouring countries (Clarke, 2012).

<sup>93</sup> According to Farole (2011), 35% of investments within the Kenyan zones were controlled by local investors in 2008. He does, however, not distinguish between firms that are fully and partly owned by locals.

investments in the zones through a joint venture linkage programme.<sup>94</sup> These programmes comply with Kenya's aim to empower small-scale producers, and also to change the perception that the EPZ programme favours foreign over domestic investment (KEPZA, 2007, 2012). Within the zones in 2012, 25.6% of firms were owned by Kenyans, 50% by foreigners, and 24.4% of firms were joint ventures. The share and size of domestic investments have hence increased within the zones since 2007, as targeted, though fully owned firms are still fairly lower.

### **3.3.4 Wages, Labour Productivity, and Working Conditions**

Prior to 2005, the Kenyan government did not allow EPZ workers the freedom to unionise or engage in collective bargaining. Other social regulations were also partly reduced as an incentive to attract investors. Inspectors were, moreover, not allowed within the zones to ensure adequate working conditions (Farole, 2011; LaRRI, 2000; Kimungi, 2004). However, today firms within the zones are subject to the same labour regulations as other companies in Kenya, and minimum wages and the right to join unions apply.<sup>95</sup> Farole (2011) finds the wages within the zones on average are 22% higher than minimum wage. The minimum wage in Kenya, however, is low, and argued to be less than the level needed to ensure a decent standard of living for workers.<sup>96</sup> Kenyan labour laws have been found to be weak and far from international standards, and Kimungi (2004) finds that the workers within the Kenyan zones have put up with long hours and unpredictable work, and many are only hired on a casual basis. Farole (2011) finds 20% of the workforce within the zones was hired on a temporary basis in 2008. This is relatively high compared to many other zones and may be due to labour market rigidities or high uncertainty. The use of temporary employment has an effect on workers' ability to unionise. Union membership of workers within the Kenyan zone programme has remained low. In 2008, only 14% of workers were unionised according to Farole (2011).

Kenya has a well-educated population relative to the region.<sup>97</sup> Yet, average labour productivity and total factor productivity in Kenya saw a decline between 1960 and 2000 in

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<sup>94</sup> EPZ regulations do not include any obligations to have Kenyan shareholders (KEPZA, 2013).

<sup>95</sup> EPZ firms aspired to have minimum wages repealed again, to increase competitiveness with Asian countries (McCormick, 2006).

<sup>96</sup> See, e.g., Omolu (2006) and Kimungi (2004).

<sup>97</sup> According to the World Bank (2013a), 87% of adults in Kenya are literate, which is relatively high compared to neighbouring countries but lower than China and some other African countries, such as Namibia and

both absolute and relative terms, with a negative effect on economic growth (Kimuya, 2005).<sup>98</sup> Chemengich (2010) finds labour productivity to be comparable to China and India. Kenya however has a higher cost of living, which affects the country's ability to lower wages to the level necessary to have competitive labour unit costs, which in turn affects the country's ability to compete in labour-intensive manufacturing.<sup>99</sup> Even though the average wage in Kenyan zones is lower than in many other African zones, such as Lesotho, Senegal, and Nigeria, it is still higher than in Asian countries, such as Bangladesh, China, and India (Farole, 2011).<sup>100</sup> Labour costs are currently increasing and can potentially impede growth in the manufacturing sector without a subsequent increase in labour productivity (Chemengich, 2010).

### 3.5 Conclusion

The Kenyan government remains faithful to zone programmes, and their expansion is an important part of the country's development strategy. The zones attract a significant share of foreign investments, and exports from the zones have contributed to increasing manufacturing exports and reducing the reliance on primary exports. Zone activity, however, remains too low for the zones to have a significant impact on economic growth or unemployment in the country. Large parts of the country remain undeveloped, and unemployment and poverty levels are still high. The increase in higher-value production has been limited and most manufacturing activities are still engaged in low-value-added manufacturing. Significant investments are needed to improve infrastructure, labour productivity, and the investment climate in order to attract greater investments within and outside the zones. However, a study by Kingombe and Te Velde (2013) finds that employment within the zones has contributed to an increase in workers' labour productivity.

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Zimbabwe. The share of students (3.1%) that enrol in tertiary education is also relatively high compared to the median level of 1.95% in SSA (IMF, 2012b).

<sup>98</sup> The decline in average labour productivity may have been a result of labour moving from higher to lower productivity activities, as displaced workers from state-owned companies ended up in less productive activities in the informal sector (see, e.g., McMillan & Rodrik, 2011). Labour productivity relative to the US also worsened in the period. In 2000, labour productivity was 25 times higher in the US than in Kenya, up from 20 times higher in 1961. Technological breakthroughs in developed countries also had a negative effect on productivity relative to other countries (Kimuya, 2005).

<sup>99</sup> Farole (2011) estimates that the cost of living is 20% higher in the African countries in his study than in non-African countries.

<sup>100</sup> Average monthly wages for unskilled labour in Kenya are US\$117, compared to US\$150 in Lesotho, US\$202 in Nigeria, and US\$225 in Senegal, while the average in Bangladesh is US\$46, less than half of the level in Kenya (Farole, 2011).



EPZ firms' use of training facilities for the workers has seen an increase, and these skills are expected to reach the domestic economy. Public universities and training programmes, furthermore, offer education and training to assist industries. However, studies find linkages between training institutions and industries to be poor, suggesting that the skills taught at university and in training programmes need to be better tailored to industries' needs.

The textile and apparel sector has suffered from a decrease in competitiveness relative to Asian producers, due to the end of MFA, among other factors. Market access through AGOA are an important means of keeping textile and apparel firms in Kenya, but the trade agreement remain somewhat uncertain, as Kenya has high levels of corruption and is not yet able to produce large-scale competitive inputs to the textile and apparel sector. The textile and apparel industry is however still argued to have significant growth potential, and textile and apparel exports remain the fourth-largest merchandise export commodity (see, e.g., Nguku, 2010). Firms within non-apparel sectors within the zones have increased. Kenya appears to possibly have a better competitive advantage in these sectors. The new non-apparel firms are, however, less labour-intensive relative to the textile and apparel firms, and employment within the zones has been limited and is lower than the peak in 2004–2005 despite the increase in firms operating within the zones.

## Chapter 4

### Case Study – Lesotho

#### 4.1 Introduction

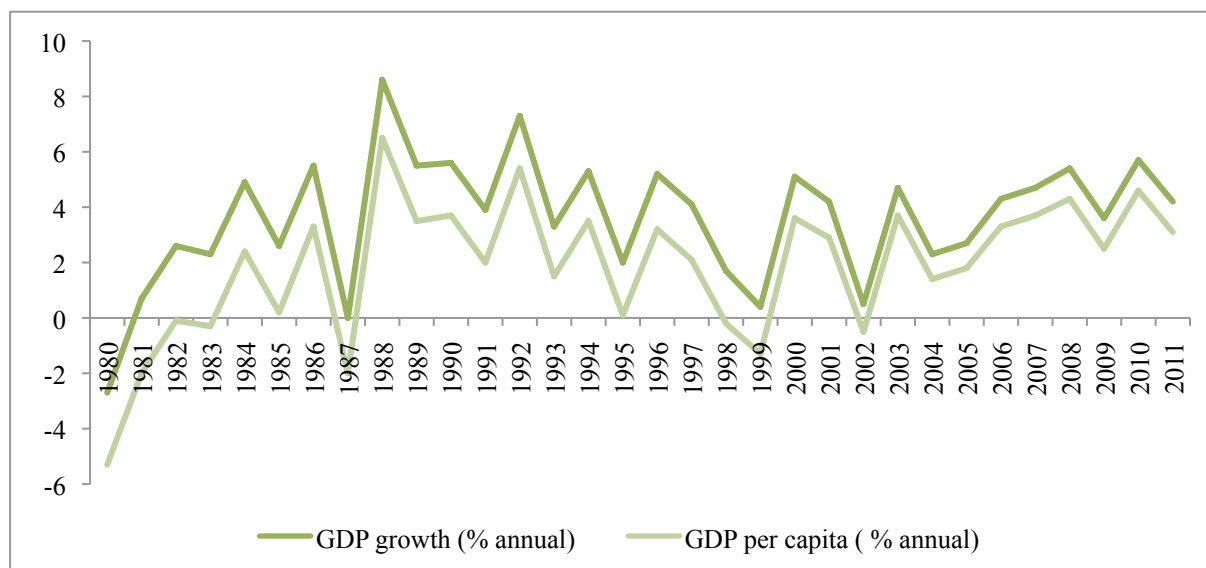
Lesotho is among the smallest countries in the world, both in terms of land area and population. The country is landlocked within South Africa, the largest economy in Africa. Lesotho became independent from Britain in 1966 and is today one of three remaining constitutional monarchies in Africa. The country's history includes military interventions, political unrest, and postelection violence, but Lesotho is today a relative stable democracy. While GDP growth has seen large fluctuations, it has been positive in the last three decades. GDP per capita has doubled since 1980 (see figures 4.1 and 4.2). The World Bank classifies Lesotho as a lower-middle-income country, but the country has one of the most unequal distributions of income in the world, and poverty is still high, especially in rural areas<sup>101</sup> (World Bank, 2013a). The country remains a LDC according to the level of its socioeconomic development as measured by the UN. Like other countries in this group Lesotho is mainly agrarian and has both low productivity levels and low levels of investment. Subsistence farming is still the main source of employment, employing about 40.6% of the economically active population. Unemployment is high, especially among the youth (World Bank, 2013a; ILO, 2012).

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<sup>101</sup> The Gini-coefficient was 52.5 in 2005 (World Bank, 2013a).

Figure 4.1.

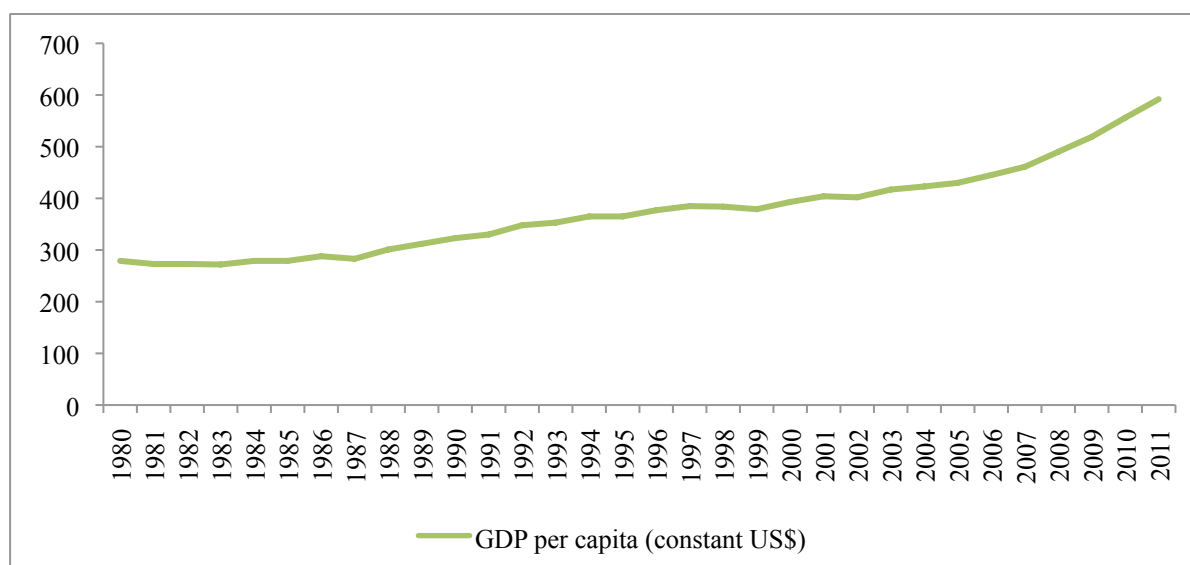
GDP growth 1980–2011 (% annual)



Source: World Bank (2013a)

Figure 4.2.

GDP per capita 1980–2011 (constant US\$)



Source: World Bank (2013a)

The Lesotho National Development Corporation (LNDC) was established in 1967, and its mission is to “initiate, promote and facilitate the development of manufacturing and processing industries, mining and commerce in a manner calculated to raise the level of income and employment in Lesotho” (LNDC, 2009, p. 2).<sup>102</sup> LNDC is fully owned by the

<sup>102</sup> The LNDC was established by the LNDC Act No. 20 of 1967. The Act was later amended in 1990 and again in 2000.

government, and falls under the Ministry of Trade and Industry, Cooperatives, and Marketing (MTICM). The corporation aims to enhance foreign and domestic investment and to encourage public-private partnerships.<sup>103</sup> The LNDC has particularly aimed to attract labour-intensive industries, specifically to generate much needed employment opportunities by seeking investors who rely on low-technology and low-skilled labour<sup>104</sup> (LNDC, 2000). LNDC-assisted firms are divided into a leasehold portfolio and an equity portfolio. The equity portfolio is further split between subsidiaries and associate companies, according to the corporation's share in the company.<sup>105</sup>

Lesotho offers a zero tax rate on manufacturing profit from goods sold outside of the Southern African Customs Union (SACU).<sup>106</sup> The country had a 15% flat tax rate in the period 1990–2006, in contrast to many other SSA countries trying to attract FDI with the aim to gaining more long-term investments. A zero tax rate was however reintroduced in 2006 to improve competitiveness of the industry (International Finance Corporation (IFC), 2010; World Bank, 1999). A 10% tax rate applies on profit from manufacturing goods sold within SACU. Domestic sales are otherwise not restricted (LNDC, 2013).

Foreign investors are not allowed to own land in Lesotho, but may build property on rented land or lease buildings owned by the LNDC. The industrial areas, or zones, are located in Nyenye and Maputsoe, in the north of Lesotho and close to the South African border; Maseru West and Thetsane, two industrial areas in the suburbs of Maseru, the capital of Lesotho; and Mohales, south of Maseru. Most manufacturing plants are located in the Maseru and Maputsoe areas. In 2010 there were 7 industrial estates under the LNDC, with 139 factory shells. The total costs associated with providing the infrastructure and services necessary for investments is not available (LNDC, 2010).

In addition to offering industrial and commercial buildings, the LNDC offers a wide range of investment support services for foreign and domestic investors, such as serviced industrial and commercial areas, and support services for businesses, i.e., assistance with

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<sup>103</sup> “The purpose of the Corporation is to initiate, promote and facilitate the development of manufacturing and processing industries, mining and commerce in a manner calculated to raise the level of income and employment in Lesotho” (LNDC Act No 13 of 1990).

<sup>104</sup> The vision of LNDC is to have an 80% employment rate and to graduate Lesotho from the group of LDCs by 2020 (LNDC, 2009).

<sup>105</sup> Associate companies are companies where the LNDC holds between 20% and 50% of the equity share capital, while the corporation's share in subsidiary companies ranges between 51% and 100% (LNDC, 2005a).

<sup>106</sup> SACU consists of Botswana, Lesotho, Namibia, South Africa, and Swaziland.

permits and licenses, company registration, and with other industrial relations issues.<sup>107</sup> The corporation is to take care of all administrative procedures and to function as a one-stop shop for all red-tape procedures (LNDC, 2013). Table A4 lists the main incentives given to investors.

## 4.2 Success of Lesotho's Industrial Areas

### 4.2.1 FDI, Exports, and Export Diversity

In the early 1980s, manufacturing mainly consisted of the food and beverage industry, which made up 72.7% of manufactures. Textile and apparel production started in Lesotho in the mid-1980s for South African-based firms to circumvent the sanctions that were imposed on South African goods by the US and Europe. Most of the owners of the firms that moved to Lesotho were of Taiwanese origin (LTEA, 2013; IFC, 2010). Manufactures grew slowly but steadily between the start of 1980s through the mid-1990s, but then slowed down due to social and political unrest in the country. Exports were mainly destined for South Africa (CBL, 2005). The economy was highly dependent on remittances from migrant workers in South Africa. In the late 1980s remittances made up almost half of the country's gross national product (KoL, 2004).

Table 4.1.

The textile and apparel sector in Lesotho, 1985–2008

Year	Share of GDP (current prices)	Exports (\$ million)	Textiles exports (% of total exports)
1985		6	2
1990	3.1	35	5
1995	4.9	80	50
2000	7.9	138	65
2005	13	528	78
2008	11.9	487	52

Source: IFC (2010)

<sup>107</sup> The corporation may also provide financial assistance and equity participation in projects considered to be strategically important to the economy of Lesotho (LNDC, 2013).

Lesotho was one of the first SSA countries that qualified for AGOA benefits.<sup>108</sup> Foreign investments and export levels grew after 2000. The number of leasehold firms saw a significant increase (see figure 4.3). Asian investors, mainly people of Taiwanese origin, were still the main investors (AEO, 2012b; CBL, 2005). Export earnings from the manufacturing sector exceeded remittances from South Africa in 2001. The manufacturing sector also surpassed the agricultural sector as a share of the country's GDP, as illustrated in figure 4.6 below. The textile and apparel sector moreover became the largest source of domestic formal employment, as is further elaborated below (CBL, 2005). The value of textile exports, according to data from the IFC (2010), increased by 282% between 2000 and 2005, to about US\$530 million in 2005, making up almost 80% of Lesotho's total exports (see table 4.1). Manufacturing exports made up 90% of exports, as seen in figure 4.4, which makes Lesotho unique compared to other SSA countries, which mainly have relied on exports of natural resources. The increased exports were primarily destined for the US, which received textile and apparel products with a value of US\$456 million in the end of 2004. Lesotho was now the largest SSA exporter to the US of textile and apparel products, and known as the 'jeans capital of Africa'. In 2005 the US received 83.4% of total exports from the country (see figure 4.5).<sup>109</sup> Relatively low inflation in China had a positive effect on input costs in the period, and a depreciation of Lesotho's loti in relation to the US dollar also had a favourable effect on exports during this period. An appreciation of the currency in 2004, however, had a negative effect on the manufacturing sector. US retailers moved orders from Lesotho to more competitive countries such as China and India in anticipation of the end of the MFA. By the end of 2005 textile and apparel exports to the US had declined to US\$391 million (LNDC, 2004, 2005a; CBL, 2005).

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<sup>108</sup> Lesotho also has preferential market access to the EU through the Everything but Arms (EBA) agreement and the Cotonou agreement, as it is a LDC. Special market access is also given to some products to a range of countries including Australia, Canada, EU, Japan, Turkey, Switzerland, Norway, Iceland, and Liechtenstein, among others (LNDC, 2013; MTICM, 2013).

<sup>109</sup> See also Collier and Venables (2007).

Figure 4.3.

## Number of LNDC-assisted firms



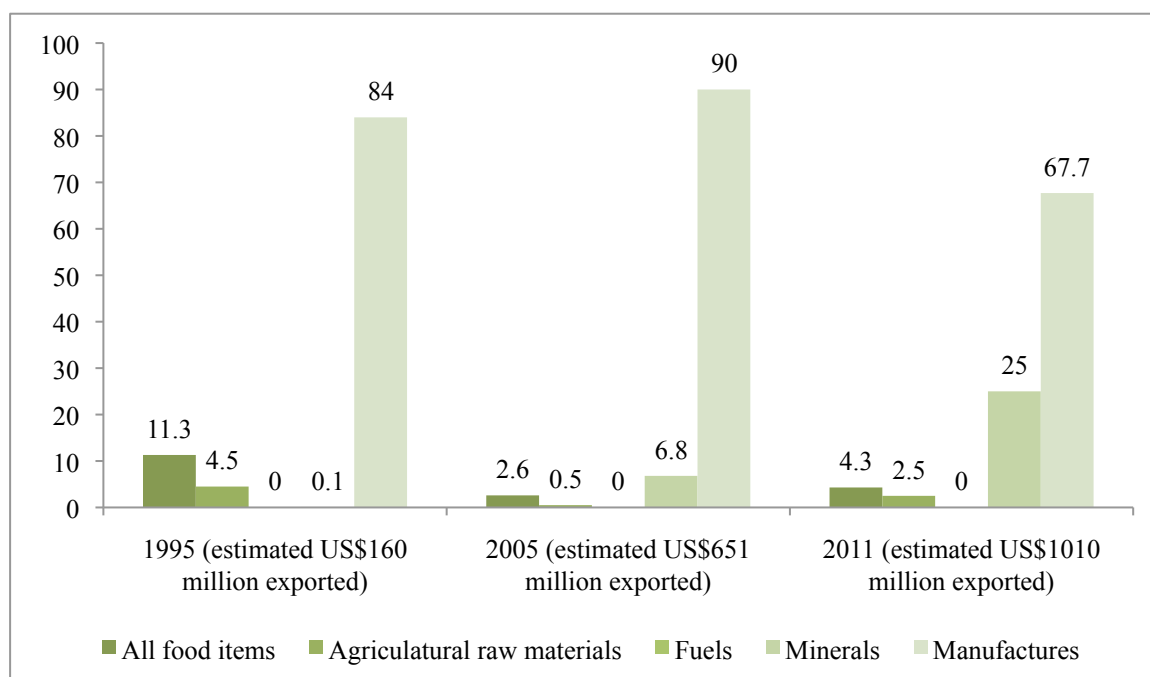
Source: LNDC (2001–2010)

The end of the MFA caused a significant increase in price competition for Lesotho's export manufacturing. There was also uncertainty linked to an extension of the third-party provision under AGOA in 2004. The increase in competition and uncertainty about further market access to the US resulted in several companies closing down or retrenching workers, causing a significant decline in textile and apparel exports. The decline had an effect on total manufacturing exports (CBL, 2005; LNDC, 2005a). The visible vulnerability of future market access to the US and the high reliance on one product and one market, the US market, made the government put emphasis on targeting other export markets, such as the SACU and the EU, and to increase diversity in industrial production by targeting investments in nonapparel industries (LNDC, 2005–2010).<sup>110</sup>

<sup>110</sup> Investments within nonapparel production, such as water bottling, electronics and electrical assembly, and canned fruit and vegetables are especially encouraged today (LNDC, 2013).

Figure 4.4.

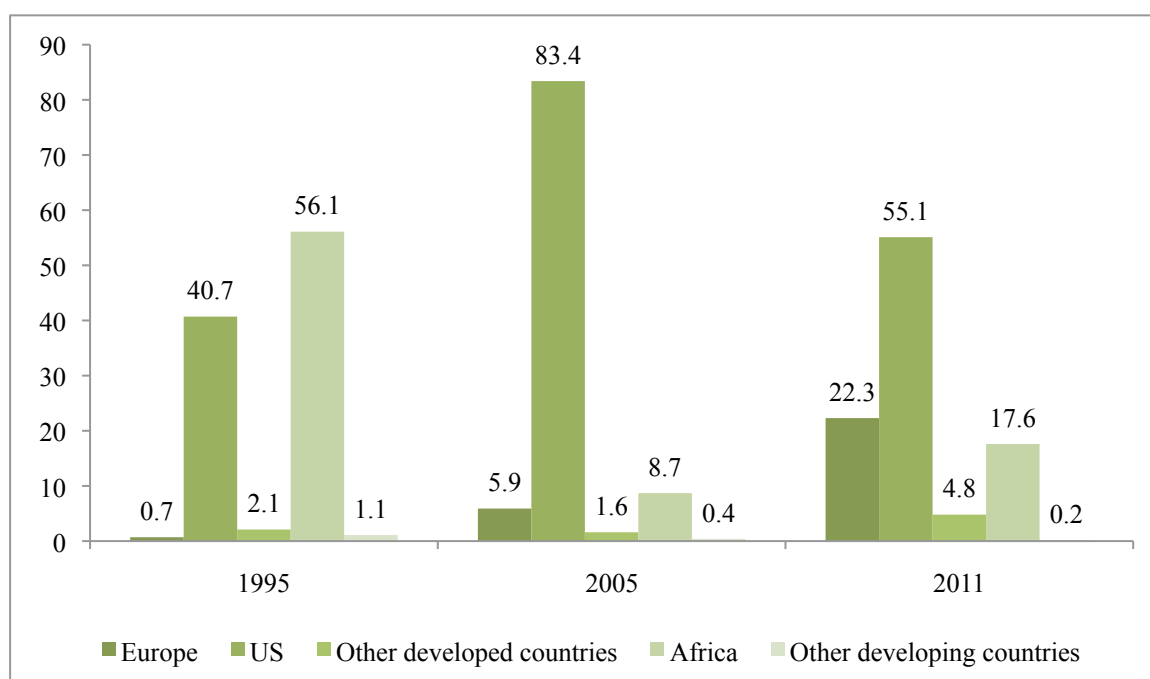
Export structure (in %)



Source: UNCTAD (2012b)

Figure 4.5.

Export structure by destination (in %)



Source: UNCTAD (2012b)

The extension of the third-country fabric-sourcing provision under AGOA attracted new investments and contributed to a positive development within the textile and apparel



sector. Firms within other types of industries also slowly emerged, such as water bottling, cigarette packaging, and screen-printing. However, investments and exports later declined, due to low US demand, because of increased competition from Asian producers, poor global economic conditions, and an appreciation of the loti.<sup>111</sup> The apparel industry in Lesotho also experienced an increase in competition after Mauritius was given LDC status under the AGOA in 2008, and hence qualified for the third-country fabric-sourcing provision under AGOA (see LNDC, 2009). Measures were taken to increase the relative competitiveness of the industry, such as reduced taxes and leases for industrial buildings (see table 4.1). Exports, including textiles and apparel, to South Africa have however seen a sizable increase, which has helped keep textile and apparel production plants in the country even as US demand declined (LNDC, 2010). Manufacturing as a share of total exports declined, from 90% in 2005 to 67.7% in 2011. However, although manufacturing exports declined some in the period, the decline is mainly due to a notable increase in mining exports after the reopening of the Letseng diamond mine (see figure 4.4).<sup>112</sup> The share of manufacturing of GDP has also declined after a notable increase following the year 2000, as is seen in figure 4.6.

The diversity in industrial production is increasing, but at a very slow pace, and investments are still mainly from East Asia, primarily Taiwan, although investments from South Africa have increased in recent years (LTEA, 2013; Farole, 2011). Eighty-five percent of LNDC firms in March 2010 were clothing and textile producers, 6% produced footwear, 2% were agri-processors, and 3% produced electronics. The textile and apparel sector has remained the main sector within the leasehold portfolio, while the equity portfolio holds food and beverage firms, a hotel, a retail firm, and a brick producer (LNDC, 2010). The share of Lesotho's total exports to Europe and to Africa, mainly within the Southern African Development Community (SADC) region, has seen a notable increase, reducing the share of total exports to the US, as seen in figure 4.5.<sup>113</sup> This can partly be explained by a decline in textile and apparel exports to the US. Although exports to the US improved by 28.6% from 2010 to 2011, textile and apparel export were only US\$315 million in 2011 from US\$456 million in

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<sup>111</sup> The LNDC views Mauritius as a direct competitor to Lesotho's apparel industry's exports to the US (LNDC, 2009).

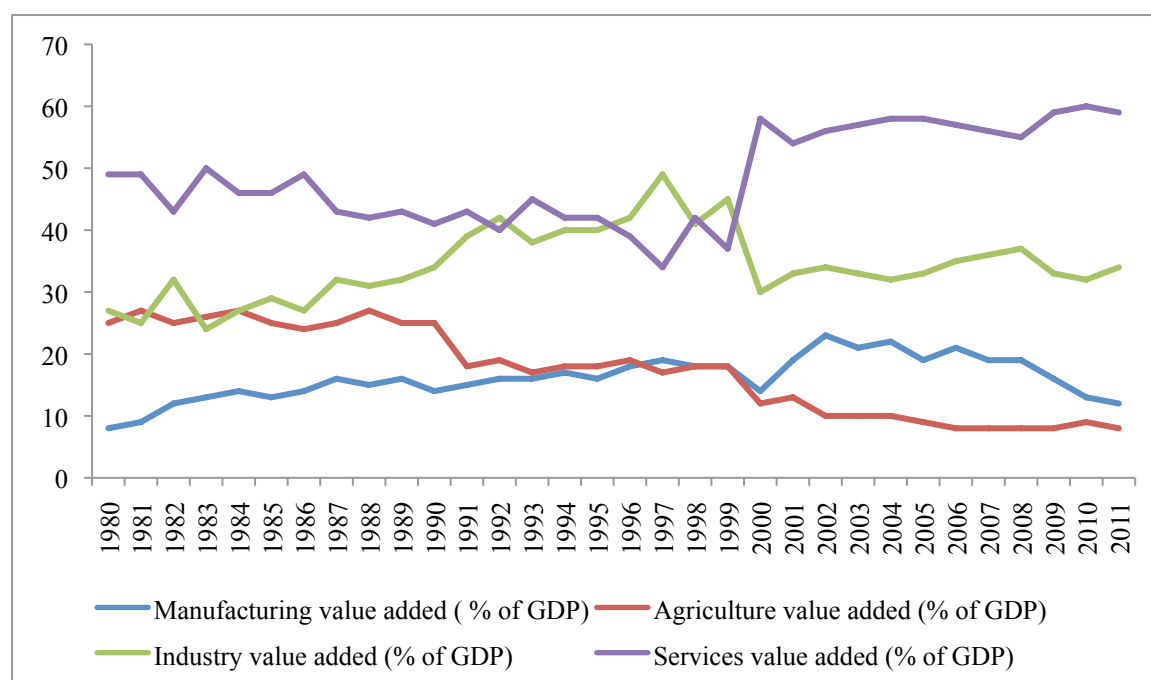
<sup>112</sup> See also LNDC (2013).

<sup>113</sup> SADC consists of Angola, Botswana, the Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, the United Republic of Tanzania, Zambia, and Zimbabwe.

2004 (USTR, 2013; LNDC, 2005a).<sup>114</sup> Poor global economic conditions in recent years have not only affected the manufacturing sector, but also diamond exports, which are mainly exported to Europe, and remittances. The net trade of goods and services did for this reason worsen, and the current account became negative in 2009.<sup>115</sup> The GDP growth rate has remained positive, but this is mainly due to public investments (World Bank, 2013b).

Figure 4.6.

Value added in different sectors



Source: World Bank (2013a)<sup>116</sup>

Lesotho stands out relative to many other African countries, as about 90% of FDI to Lesotho has targeted export-oriented manufacturing, mainly the textile and apparel sector. Most foreign investments to African countries are linked to the extraction of natural resources (AEO, 2012b). International Finance Corporation (IFC) (2010) estimates that the textile and apparel sector contributed to about one-third of GDP growth (in real terms) in the period 1999 to 2008. Export earnings from industry have been important to improve the net trade, and/or

<sup>114</sup> Knit and apparel products made up 82% of exports to the US in 2011; total exports were US\$384 million (USTR, 2013).

<sup>115</sup> See, e.g., CBL (2009) for more information.

<sup>116</sup> Value added is defined as “the net output of a sector after adding up all the output and subtracting intermediate inputs” (World Bank, 2013a). Industry here includes manufacturing, mining, construction, electricity, water, and gas. Services include wholesale and retail trade, transport, government, and financial, professional, and personal services (education, health care, real estate services).

to make larger imports feasible. However, as export-oriented manufacturing mainly has consisted of textiles and apparel to the US, diversity within the manufacturing sector has been limited. While foreign investments are essential for the country's manufacturing sector, Kingombe and Te Velde (2013) do not find proof that the zone programme has contributed to an increase in higher-productivity activities or to a structural transformation of the economy. Lall (2005) furthermore find little evidence of FDI increasing higher-value-added production in Lesotho.

#### 4.2.2 Employment

Table 4.2.

Employment in LNDC-assisted firms, 2000–2011

	Percentage of LNDC-employment within textile and apparel sector	Aggregate employment within leasehold companies under LNDC
2000	90%	Approx. 18,500
2001	88%	27,552
2002	72 %	31,050
2003		43 525
2004		48,564
2005	77%	48,818
2006	92 %	44,318
2007		52,169
2008	91%	45,650
2009		44,227
2010	85%	44,098
2011*		40,861

\* No Annual Report from LNDC for the year. All together, 40,861 workers were employed within LNDC-assisted industries (CBL, 2011).

Sources: LNDC (2000–2010); CBL (2003–2011)<sup>117</sup>

The initiation of AGOA had a significant effect on employment within the textile and apparel sector. Employment increased by 9,000 workers from 2000 to 2001. In the end of the 2001 financial year there were about 27,500 jobs within leasehold companies under the LNDC. The textile and apparel industry became the largest single employer of domestic

<sup>117</sup> Numbers do vary some between the different sources, and these differences are most likely to depend on the time of the year employment is measured. Annual reports from the LNDC and the CBL are only available after 2000.

formal employment within the country in 2001, employing about 25,000 workers. The sectors hence constituted almost all employment within leasehold firms under LNDC. It is estimated that between 80% and 85% of the workers within the textile and apparel sector are women (Farole, 2011; ILO, 2012). Prior to 2001, the main source of domestic formal employment was the public sector. The mining sector in South Africa still employed more workers, as seen in figure 4.9 (LNDC, 2001, 2002).

Employment within LNDC-assisted firms increased to 48,564 workers in 2004. More than 7,000 workers lost employment between March 2004 and March 2005. Remaining firms hired some of the workers who were let go, especially skilled workers. A few new investors also arrived, helping to somewhat reduce the drop in total employment (LNDC, 2005a).<sup>118</sup> The extension of the third-country fabric-sourcing provision did however have significant positive effect on investments, and employment within leasehold companies increased by 18% from 2006 to 2007 to 52,169 workers. Employment later declined, as seen in table 4.2 and figure 4.7. The decline in LNDC-assisted employment and a concurrent increase in public sector employment in recent years have caused public sector employment to exceed employment within LNDC-assisted industry in 2010.<sup>119</sup> Employment within the public sector has also come to exceed the number of migrant workers in South Africa, as employment in the latter has undergone a continuous decline, as seen in figure 4.9.<sup>120</sup> It is estimated that about 80% of manufacturing employment in Lesotho in 2008 and 2009 was within the zones or LNDC-assisted industrial areas (Farole, 2011; ILO, 2012). The government aims to expand the manufacturing sector to realise employment creation and poverty reduction. It is hoped that employment within nonapparel firms will increase further with time (LNDC, 2013).

Despite the zones' success in creating employment relative to its population size and to other African countries, the formal sector remains unable to absorb the labour entering the market each year, estimated to be about 25,000 people. Hence, the share of employment within the informal sector is likely to increase and low-productivity agriculture to remain as

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<sup>118</sup> Farole (2011) estimates about 53,000 people were working within the zones in 2004, and a loss in employment of 8,000 in the period 2004 to 2008, or 15% of workers at the 2004 peak.

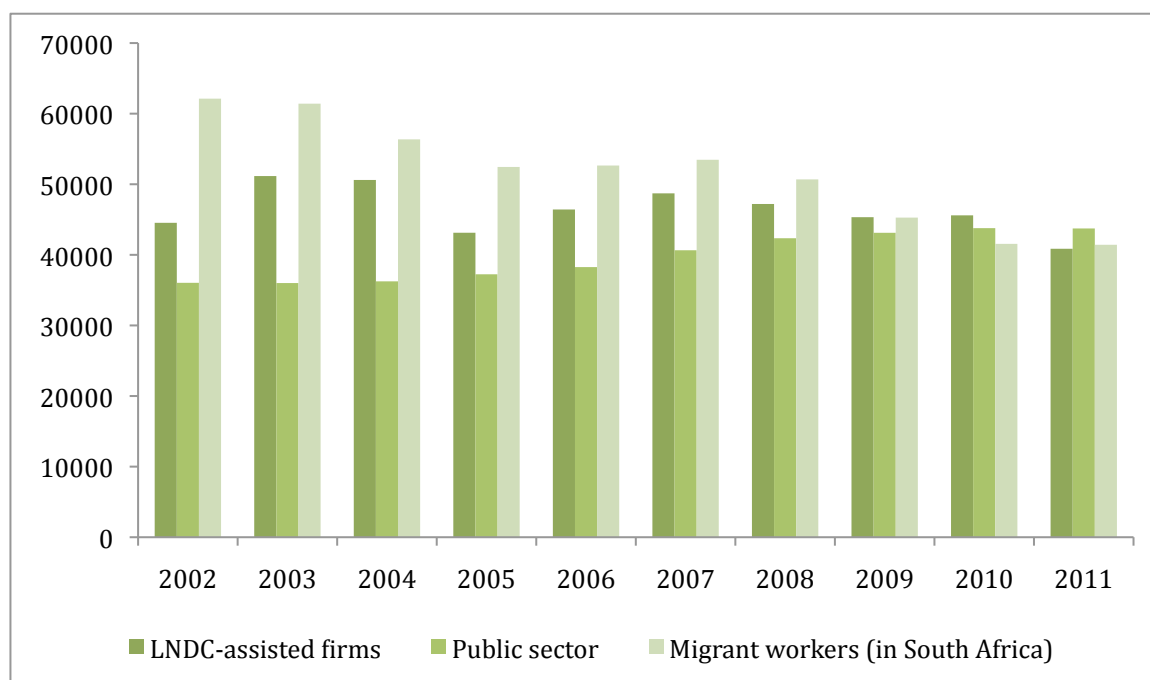
<sup>119</sup> Employment within the equity portfolio has declined from almost 2,500 in 2001 to less than a 1,000 in 2009 (LNDC, 2001, 2009).

<sup>120</sup> About 120,000 men were employed in South African gold mines in the late 1980s; by 2004 the number was halved, and in 2011 the number of workers was reduced by almost two-thirds. The retrenched workers have had few opportunities for other wage employment in Lesotho (KoL, 2004; CBL, 2011).

the main source of employment for a while longer. Unemployment remains high and youth unemployment is a particular challenge for Lesotho (AEO, 2012b).<sup>121</sup>

Figure 4.7.

Employment in LNDC-assisted firms, public sector, and mines



Source: CBL (2003–2011)

### 4.2.3 Training and Labour Productivity

The government encourages the training of workers through tax incentives; costs related to training are allowable at 125% for tax purposes. Training facilities has also been established (LNDC, 2013). AIDS-awareness programmes and HIV interventions have reduced absenteeism and improved labour productivity.<sup>122</sup> The World Bank has also established two training centres in Maseru and Maputsoe, the two largest industrial cities to enhance skill development through the Trade for Aid-initiative.<sup>123</sup> According to the Bank, the

<sup>121</sup> Only 45.1% of the population between 15 and 24 years old participates in the labour market (AEO, 2012b).

<sup>122</sup> According to World Bank (2013a), 23.3% of the population between 15 and 49 years was HIV-positive in 2011, one of the highest rates in the world. HIV/AIDS is found to reduce both labour supply and have a negative impact on labour productivity due to sick workers and higher labour turnover (Fox et al., 2004).

<sup>123</sup> The World Bank-supported training centres aim to develop new skills, improve skills, and increase labour productivity to increase the competitiveness of Lesotho's industry. Workers are trained in basic sewing, quality control, merchandising, export documentation, and marketing. The World Bank also targets increasing the share of locals within management positions (World Bank, 2009).

training centres have improved the chances for unskilled workers to be promoted within the textile and apparel industry, and also made it easier for investors to differentiate products (World Bank, 2011).

Lall (2005) argues that though foreign-owned industrial firms in Lesotho have contributed to improving operating skills, work attitudes, trade infrastructure, and support services, training and productivity improvements are small. On-the-job training, such as the use of sewing machines, cutting, and pressing, is limited to basic production; the skills workers acquire for this reason are narrow, and productivity is little improved. According to Lall (2005), the Taiwanese investors make little effort to transfer technology and train their workers, even relative to other MNCs. The main group of investors are also reluctant to promote locals to managerial positions, and “[m]ost supervisory, technical, and managerial jobs remain with expatriates, even in firms that have been in Lesotho for a decade or more” (Lall, 2005, p. 1008). They are further poorly integrated with the local population, and few plan on settling. He further finds no notable entrepreneurial response by local firms. Farole (2011) finds that one in four managers is foreign, though he is unclear if he includes the many Asian immigrants as locals or foreigners. The government encourages an increase of locals at management levels, and payments made to foreigners at management levels are subject to a withholding tax of 10% (LNDC, 2013). Farole (2011) further finds labour circulation between zone-based firms and local firms to be low, reducing the possible transfer of skills and knowledge to the domestic economy.

#### **4.2.4 Backward Linkages**

The government aims to increase use of local inputs to both enhance greater vertical integration and backward linkages, and to secure sustained market access to the US. The textile and apparel sector in the industrial areas only sourced 9% of inputs locally in 2008. The Famosa denim mill, located in the Thetsane industrial area, was completed in 2003 and has seen investments of more than \$US100 million. The mill has generated employment opportunities, but cotton is mainly sourced from other African countries, as the potential for significant cotton production in Lesotho is low.<sup>124</sup> Another textile mill is located in Mohale’s Hoek (LTEA, 2013; Central Bank of Lesotho (CBL), 2003). The mills export denim, cotton, and cotton-blend yarn to Nicaragua, Bangladesh, Hong Kong, Sri Lanka, Jordan, Kenya,

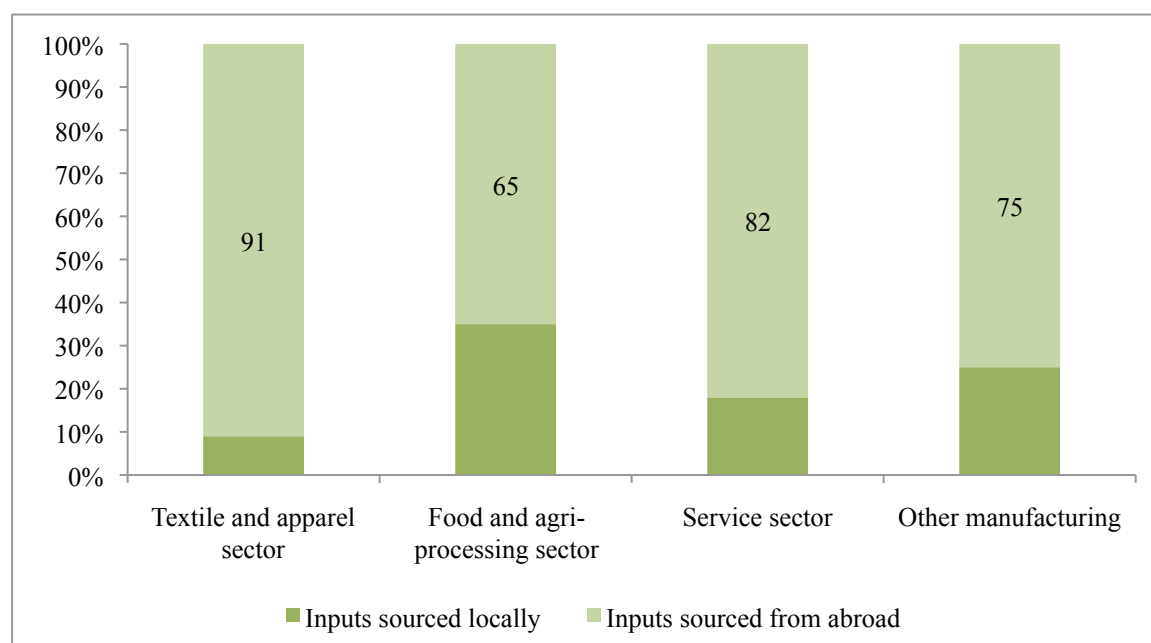
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<sup>124</sup> Employment of small-scale farmers is hence limited. Lesotho also remains dependent on food imports. Food security through domestic production is not seen as a viable target, as Lesotho does not have sufficient fertile land to grow enough food. High population growth and land degradation put further pressure on land resources (KoL, 2004; UNDP, 2013).

Egypt, Madagascar, and Mauritius, in addition to selling to the local market. The mills hence contribute to increased foreign exchange earnings (LTEA, 2013). However, prices, quality, or quantities may be questioned as most inputs in the textile and apparel sector are sourced from Asia, especially India and Pakistan. The LNDC aims to attract investments to a knitted fabric mill and to production of buttons and zippers to complement the textile and apparel industry (LNDC, 2013). On average 14% of inputs in the zones were sourced from local markets in all sectors (see figure 4.8) (Farole, 2011; IFC, 2010). The increase in nonapparel industry within LNDC is likely to have had a positive effect on the share of local inputs. However, the decline in textile and apparel exports, and in salaries paid from the sector, is likely to have offset any increase in foreign exchange earnings. Data on total domestic expenditures from the industry within the industrial areas is not available to make an evaluation of the full foreign exchange earnings linked to salaries, utilities, local inputs, and other domestic expenditures.

Figure 4.8.

Average local input use within the zones in 2008, by sector (in %)



Source: Farole (2011)

Local investments within the industrial areas are low, keeping local profit small. Sixteen of 74 LNDC firms were local projects, while foreigners controlled 58 of the firms in 2009 (LNDC, 2009). According to Farole (2011), 20% of investments within the zones in Lesotho were locally controlled in 2008. Taiwanese and South Africans control most of the apparel and textile sector. The LNDC aims to increase domestically owned industrial firms.

Financial obstacles do however remain an important barrier for domestic investments (see, e.g., World Bank, 2009). A credit guarantee scheme has for this reason been initiated to address the financial challenges many domestic investors meet, in order to increase investments from the local private sector. Ten million maloti were approved to support the scheme in 2010 (LNDC, 2010).<sup>125</sup>

### 4.3 Lesotho's Investment Environment

#### 4.3.1 Political and Macroeconomic Stability and Overall Competitiveness

Lesotho is today a stable democracy. The country's monetary policy ensures parity between the country's currency, the loti, and the South African rand. The government keeps a monetary policy similar to its neighbour. The country is however vulnerable to foreign exchange risk, and appreciations and depreciations of the loti have had notable effect on the country's competitiveness, as seen above. Changes in the real effective exchange rate and the official exchange rate to the US dollar are shown in figures 4.9 and 4.10. The figures clearly show the depreciation in Lesotho's currency in the beginning of the 21st century, which had a positive effect on investment and exports. The inflation rate, though relatively low today, has fluctuated some and was greatly affected by the political instability following the mid 1990s, and data between 1997 and 2000 is not available as figure 4.11 below shows. The ease of doing business in Lesotho's has been somewhat improved in recent years according to the ease-of-doing-business index calculated by IFC (2012, 2013). Lesotho does, however, not have a particularly favourable ranking either globally or relative to other African countries.<sup>126</sup> The greatest obstacles to business are, according to the same report, access to finance, corruption, crime, and theft. Tax rates, inefficient bureaucracy, inadequate infrastructure and an inadequately educated workforce are further obstacles to business.<sup>127</sup> The GCI ranks Lesotho's competitiveness very low compared to the other countries in the report.<sup>128</sup> According to a survey of firms by the World Bank (2009), Lesotho does however do

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<sup>125</sup> 'Maloti' is the plural of Lesotho's currency, the loti.

<sup>126</sup> Lesotho's ease-of-doing-business rating ranked the country as number 136 of 185 countries in 2013, compared to 143 of 183 in 2012.

<sup>127</sup> Ernst and Young (2012) places Lesotho among countries of medium risk in Africa to invest in.

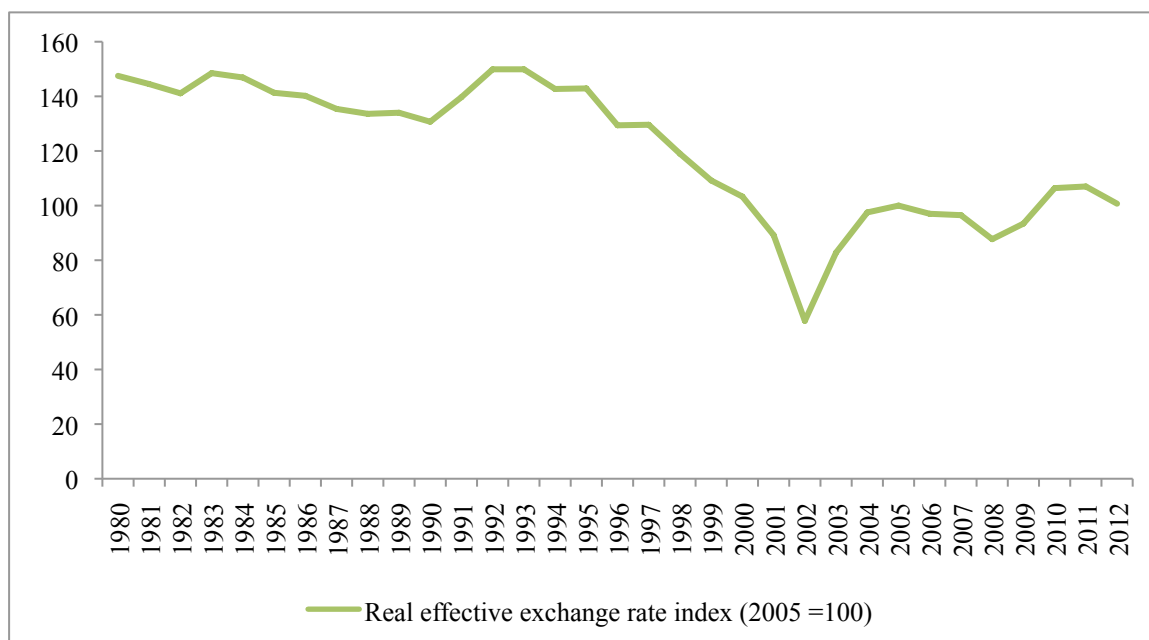
<sup>128</sup> In 2013 the GCI ranked Lesotho's competitiveness at 3.17, and as number 137 out of 144 countries. In 2008–2009, the country's GCI ranking was 3.4, with Lesotho at number 123 of 134 countries. Hence, according to the GCI, Lesotho's competitiveness has declined (WEF, 2013).



relatively well in terms of perceived obstacles to business in the overall economy compared to SSA countries and low income countries as a whole, see table A5 in appendix.

Figure 4.9.

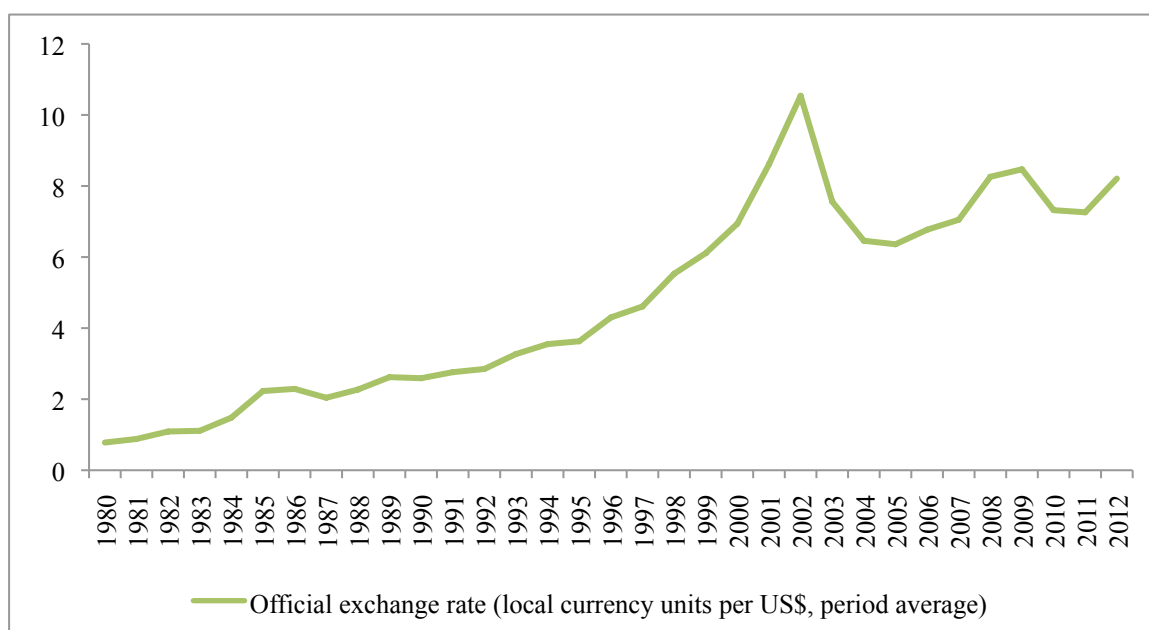
Real effective exchange rate index (2005 =100)



Source: World Bank (2013b)

Figure 4.10.

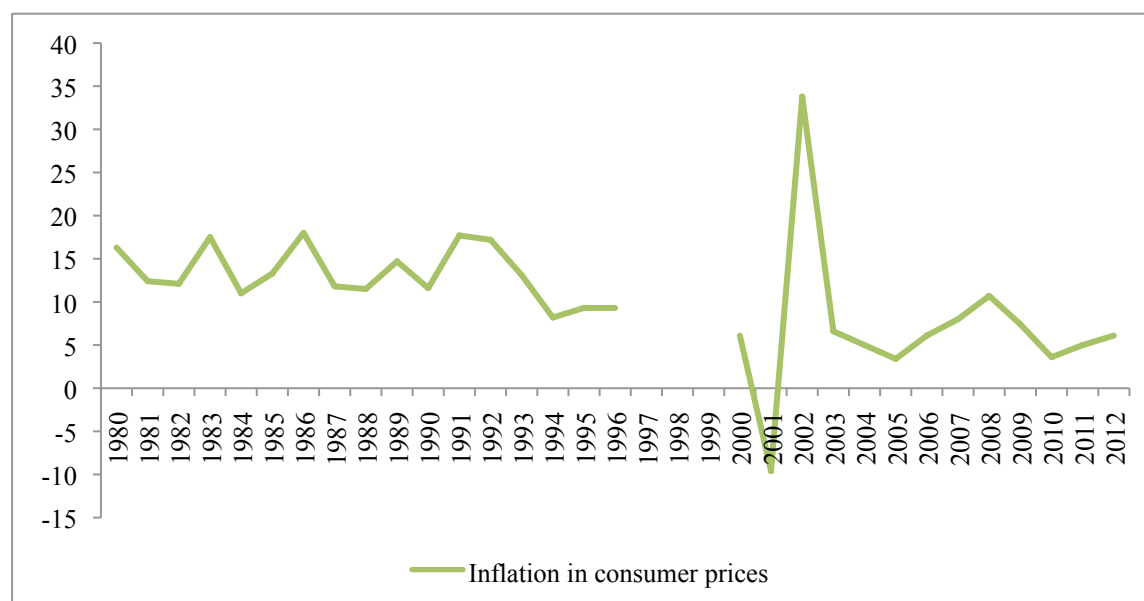
Official exchange rate (Loti per US\$)



Source: World Bank (2013b)

Figure 4.11.

Inflation in consumer prices (annual %)



Note: data from 1997 to 2000 are missing.

Source: World Bank (2013b)

### 4.3.2 Infrastructure

A one-stop-business facilitation centre was launched in 2007 to provide services for businesses and investors, including trading and manufacturing licences, import and export issuances, residency visas, and work permits. The centre has had a positive effect on the ease-of-doing business in Lesotho, according to the IFC (2012, 2013), together with new legislation for companies, and improved investor protections through the increase of disclosure requirements and improved liability schemes.

As a landlocked country, Lesotho is dependent on air transport or on transporting goods through South Africa. The capital Maseru is about 600 km away from the port of Durban, the busiest port in SSA, and 520 km from the port of East London. Maseru is connected to the South African rail network through a rail line between Maseru and Bloemfontein in South Africa. Transport costs have been reduced through significant investments in roads, but large investments are still needed. LNDC has located the industrial zones in different regions. Zones located in peripheral areas in Lesotho have however been relative less successful in attracting investors, with most investors choosing to settle in the industrial areas close to Maseru and Maputsoe. Workers have also found it more difficult to

get to industrial areas located in the less developed and populated parts of the country (LNDC, 2013; KoL, 2004; Farole, 2011).

Although Lesotho has the disadvantage of being landlocked, South African infrastructure is relatively good to other African countries and may hence put Lesotho in a better position than other landlocked countries in SSA.<sup>129</sup> Lesotho's costs of trade was significantly improved by measures enacted by South Africa in 2011 and 2012 to reduce the time, costs, and documents required for international trade. The costs associated with trading are still a considerable obstacle to business and trade, though Lesotho does relatively well when compared to other SSA and low-income countries (World Bank, 2009; AEO, 2012b). Farole (2011) does however find that reported clearance times are higher for exporters within the zones in Lesotho than in the domestic economy, suggesting possibilities for rapid improvements.<sup>130</sup>

Despite the slowdown in the manufacturing sector, the shortage of factory buildings is still perceived as an important obstacle for further investment. This shortage causes long waiting times for obtaining industrial premises, leading potential investors to lose interest. Infrastructure and factory shells are continually built through government support to eliminate the shortage, but large investments are still needed. The LNDC aims to increase investment from the domestic and foreign private sectors to develop commercial and industrial buildings (LNDC, 2013). LNDC froze and also reduced some rentals to improve the competitiveness of Lesotho's industry following the end of the MFA (LNDC, 2009, 2010).

Wastewater, solid waste management, and sanitation facilities within Lesotho remain inadequate to support industry, and have prevented some investors from settling (LNDC, 2001–2010). The significant growth in industrial waste has caused large emissions of wastewater and problems of water pollution in some industrial areas. The emissions have especially affected livestock, irrigation, and low-income households in close proximity to industrial areas. The emissions have negative effect on the social benefits and the public opinion of the industry (Gibbs & Gibbs, 2003). The growth in the textile industry and the demand for water in industrial production has also put pressure on water resources. Water shortage is however perceived as less problematic for business in Lesotho compared to SSA

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<sup>129</sup> Access to port facilities in Lesotho was given a 3.4 score out of 7, where 1 is extremely inaccessible and 7 is extremely accessible, in the Global Competitiveness Report. The quality of South Africa's port infrastructure got a 4.7, where 1 is extremely undeveloped and 7 is well developed and efficient according to international standards (WEF, 2013).

<sup>130</sup> Average reported clearance times for imports were 11 days for zone investors versus 4 days for domestic investors (Farole, 2011).

and low-income countries (World Bank, 2009). Certain operations and services have, in the interim, been sourced out to South African and domestic private firms. The government aims to attract investment through the measurement and control of emissions, water recycling and treatment plants, and reuse of waste products, especially from the textile and apparel industry (LNDC, 2001–2010).

Energy consumption has grown significantly in the last years, but traditional biomass energy dominates in most households. Lesotho is a member of the Southern African Power Pool and is connected to power utilities in the region. Despite having great possibilities for renewable energy sources, such as hydropower, solar energy, wind, and biomass fuels, the country is still a net importer of electricity.<sup>131</sup> The LNDC aspires to attract renewable energy investments for domestic sales and export (LHWP, 2013; LNDC, 2013). South Africa has seen a rather substantial increase in electricity prices in recent years, and, though prices in Lesotho remain relatively low, the country has experienced frequent power cuts due to low regional capacity (Taele et al., 2012).<sup>132</sup> Lesotho prioritizes supplying electricity to industrial areas during power outages in order to reduce losses caused by halts in production for the manufacturing sector. The supply of electricity within the zones is consequently considerably improved compared to nonindustrial areas. Industrial zones in Lesotho are for this reason ranked as the best among African zones in term of power outages (Farole, 2011). Lesotho's competitors, such as China, are however ranked much higher by WEF (2012) in addition to having a much better overall competitiveness ranking.<sup>133</sup>

### 4.3.3 Working Conditions, Wages, and Productivity

Labour costs are relatively higher in Lesotho than in several other African countries with equal incentive programmes, such as Ethiopia, Tanzania, Ghana, Kenya, Madagascar, and Mozambique.<sup>134</sup> Studies dispute if labour productivity compensates for this.<sup>135</sup> Lall

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<sup>131</sup> Great opportunities exist to improve domestic production and export of electricity to South Africa and the Southern African Power Pool, through projects such as the Lesotho Highlands Water Project. The Lesotho Highlands Water Project is a project between the governments of South Africa and Lesotho, which aims to provide water to meet a growing demand in some industrial areas and cities in South Africa, while also generating hydropower to cover the electricity needs of Lesotho (LHWP, 2013). The LNDC aims to attract investments for renewable energy within the country and make Lesotho a net exporter to its neighbouring countries.

<sup>132</sup> The quality of Lesotho's overall electricity supply is given a relatively good evaluation by WEF (2013).

<sup>133</sup> Lesotho has relatively high utility costs for telecommunications, due to an earlier monopoly in the sector according to the AEO (2012b).

<sup>134</sup> Farole (2011) finds unskilled labour costs to be higher in Lesotho than some other African countries including Ghana, Tanzania, and Kenya, and non-African countries such as Bangladesh and Vietnam. Some other African and non-African countries do however have higher costs of unskilled labour, such as Nigeria, Senegal,

(2005) finds wages in Lesotho to be comparable with East Asian countries, but productivity within firms in Lesotho to be only 30% to 70% of that of similar firms in East Asia. Labour unit costs are for this reason higher. Higher costs of living in Lesotho, compared to Asian competitors, make it difficult to reduce wages, even though unemployment in Lesotho is severe. Wage levels in the textile and apparel sector have been significantly lower than the wages received by men in the mining sector in South Africa, but Farole (2011) find wages in the zones to still be 17% higher than the national minimum wage (see, e.g., KoL, 2004). Piecework and bonuses are permitted, but only in addition to the minimum wage. The possibility to increase wages through performance may encourage greater labour efficiency (IFC, 2010). The level of minimum wages, especially in the textile and apparel sector, have been notably contested over the years, and are argued to be lower than the level needed to meet basic demands (LNDC, 2005a, 2005b).<sup>136</sup> The need to remain competitive with Asian countries remains an important objective, and wages have been frozen and in some cases reduced to be able to keep industrial firms in the country and export levels stable. The insecurity linked to the volatility of the markets in the last years has increased the number of workers with temporary employment, possibly reducing the possibility for workers to unionise (LNDC, 2010; ILO, 2012). Forty-two percent of workers are unionised, a relatively high share for both African and non-African countries according to Farole (2011).<sup>137</sup> However, Shakya (2011) argues that foreign-owned firms have improved labour standards in the country. The government aims to ensure satisfying working conditions and environmental standards in the production of material sourced locally and from abroad, in order to satisfy consumers' increasing demands regarding standards. It is also hoped that Lesotho in this way is able to stand out from its competitors even though the cost of production and transport are higher (LNDC, 2013).

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Dominican Republic, and Honduras. However, productivity levels are not included and thus not taken into account.

<sup>135</sup> See, e.g., Shakya (2011) and IFC (2010).

<sup>136</sup> The ILO provided technical assistance in setting the minimum wage in the textile sector after negotiations failed between the industry and the workers in 2011. Workers however did not find the minimum wage acceptable and protests were held in 2012 (GoL, 2013).

<sup>137</sup> Farole (2011) finds 16% of workers to be temporarily employed.

#### 4.4 Conclusion

Government-provided infrastructure, service provisioning, and tax incentives have been essential for Lesotho to take advantage of access to the US market through AGOA. The existing industry in Lesotho prior to 2000, already located there by chance, also seems to have been an important factor for Lesotho to attract further investors with the initiation of AGOA, as the Taiwanese investors attracted additional investors from Taiwan.

The zones' textile and apparel industry has been the key source of FDI, the main export commodity, and the largest source of foreign exchange earnings. The sector has also significantly increased formal sector employment, and constituted to almost half of formal sector employment. Few other opportunities exist for formal sector employment aside from the public sector and the mining sector. The growth in the manufacturing sector has contributed to positive economic growth, and an increase in GDP per capita. However, 77% of the population still lives in rural areas and primarily depends on subsistence farming, and employment rates and poverty levels remain about the same as three decades ago. Wealth is concentrated in the capital (ILO, 2012).

Foreign investors dominate the manufacturing sector, but the investments are relatively footloose, making the country vulnerable to exchange rate risk and changing conditions in the international market, such as market access and competition. The years following the end of the MFA have been challenging for the industry, with low demand from the US as the main importer, an unfavourable exchange rate, and a substantial increase in competition from China in particular. Several factories have as a result closed down, though an increase in textile and apparel exports to South Africa has helped lessen the drop in exports.

There is little evidence of either horizontal or vertical linkages from foreign investors to the domestic economy. Use of local inputs is low, especially within the textile and apparel industry. Government incentives have facilitated investments in mills using mainly African cotton. The country's prospects for cotton production are poor due to scarce arable land, which limits employment generation because it limits backward linkages. Lesotho has few natural resources to utilize in industrial production, though the government aims to encourage industries such as water bottling and clay and sandstone processing to increase diversity and take better advantage of the country's resources. Technology and knowledge spillovers from FDI moreover remain small, and although the government and the World Bank operate training facilities and on-the-job training is provided by investors, productivity improvements

remain small. Domestic investments remain low, though funds have recently been allocated to reduce financial constraints for domestic investors within the industry.

## **Chapter 5**

### **Discussion**

#### **5.1 Introduction**

This chapter's aim is to answer the research question posed in the introduction: Do EPZ programmes have the potential to contribute to long-term economic growth in SSA? The question is answered by addressing the two subquestions: Do EPZ programmes provide the benefits anticipated? What factors determine and hamper investments within SSA zones? To answer the first question, zone programmes' prospects for realizing benefits—such as increased foreign exchange earnings, export diversity, employment, demand for local inputs (and subsequent generation of indirect employment), as well as human capital and technological development, and industrial and regional development are assessed. The conditions needed for such benefits to occur, the significance of governments' incentives, and additional policies supporting the EPZ programmes are explored. Policy recommendations are included. The last section of the chapter attends to the second subquestion, and discusses EPZ programmes as a policy to increase FDI to SSA. The section also looks more closely at the significance of trade preferences on investments in SSA zones, the zones' ability to facilitate labour-intensive industry, and the zones' expected long-term effect.

#### **5.2 The Potential Benefits of EPZ Programmes in SSA**

##### **5.2.1 EPZ Programmes as a Policy to Increase in Foreign Exchange Earnings**

Foreign exchange earnings from EPZ programmes depend on a range of factors linked to the success of the particular zone programme, such as tax income, wages paid to local employees, EPZ firms' emoluments to local employees, use of local raw and intermediate inputs, prices on electricity and water utilities relative to production costs, lease income on industrial or office buildings, profit to domestic investors, and domestic sales. Tax income is often low, as EPZ firms typically pay little or no taxes on profit, or import or export duties. If



taxed on profit, multinational firms may also take advantage of transfer pricing, and record profit in low-tax countries to reduce the tax burden for the company (see, e.g. Todaro & Smith, 2009). The footloose nature of many EPZ firms makes it difficult for state and regional authorities to increase earnings by extracting a greater share of firms' surpluses, by, e.g., increasing tax rates, leases on industrial and office buildings, costs of utilities, and administrative services, as investors may relocate if such costs exceed opportunity costs (see, e.g., Romer, 1998). The significant increase in the number of zone programmes offering different tax incentives to attract investors may make it harder to attract investments with a perpetual low-tax rate. The government of Lesotho found it necessary to reduce the taxes on manufacturing profits and reduce the cost of leases on industrial buildings to improve the competitiveness of industry in Lesotho after the end of the MFA. These measures significantly reduced the government's income from the manufacturing sector. The actual loss of tax income, however, depends on whether firms settle or stay regardless of the reduction in taxes, and whether the EPZ programme succeeds in its main objective of attracting investments that would otherwise not materialize. This is difficult to ascertain, in Kenya as well, as is also argued by Rolfe et al. (2004) and Kingombe and Te Velde (2013).

### **5.2.2 EPZ Programmes as a Policy to Increase Export Diversity**

Industries within the zones may contribute to economic diversity and the composition of exports. Zone exports make up the majority of Lesotho's total exports. The textile and apparel sector has given the country an exceptional possibility to increase foreign exchange earnings and generated important formal employment opportunities. The EPZ programme in Kenya has also contributed to increase manufacturing production and total exports, yet the effect seems less evident in comparison to Lesotho. Industry composition within the Kenyan zones has changed somewhat since 2005, and food- and agri-processing provides potential for a further increase in zone activity if political and macroeconomic stability persist. Scarce data makes further analysis of the zones' effect on total exports infeasible.

Textile and apparel production and electronic assembly dominate most EPZs, though zone programmes in general increasingly include a greater range of industries. To some extent, this is likely a response to the significant growth of zone programmes and a struggle to stand out and attract attention from investors. Clusters of firms are an important incentive for additional investors, but if only a few commodities are produced within the zones it makes zone programmes vulnerable to potential changes in market access and demand. Such vulnerability is highly evident in Lesotho. Zone production in Lesotho remains largely

dependent on special market access and a small range of goods to a single market. The government has ambiguous targets for an increase in investments within nonapparel industry and new export markets. Textile and apparel exports to South Africa have increased and have been important to lessen the reduction in production when exports to the US drastically declined. Investments within nonapparel production do however remain low. Though the building up of a particular industry may have important economies of scale, it is imperative that the zones develop the capacity to adapt to changes in taste and demand in the global economy to be less vulnerable to risk, and industry diversity can support that goal. EPZ policies are also then more likely to be sustainable.<sup>138</sup> The vulnerability of an industry with a narrow line of production may also decline if export markets and group of investors are diverse, and if investors are from several different locations, as argued by, e.g., ILO (1998). Like SSA zone programmes in general, Kenya's programme includes a larger variety of industries, is less dependent on a single market, and has a more diverse group of investors, and thus was better able to adapt to a notable decline in textile and apparel exports to the US following 2005, as well as to increase production of nonapparel products. The low levels of investments within SSA zones cause single firms to potentially have considerable effect on both investments and diversity within the zones. This is evident in both Kenya and Lesotho, and the closures of relatively large firms within the textile and apparel industry have had significant effect on investments. New investments within nonapparel industry exports have also affected the diversity of the composition of firms, though the production output of many of these firms is small.

### **5.2.3 EPZ Programmes as a Policy to Generate Employment; Labour Productivity**

#### ***5.2.3.1 Employment Generation in SSA Zones***

Employment generation is one of the most evident accomplishments of many zones. By utilizing surplus labour from agriculture, and transferring labour from lower-productivity activities to higher-productivity activities, the zones are likely to have a positive effect on overall productivity in the economy by allocating resources more efficiently.<sup>139</sup> However, if labour is merely relocated from existing industry without an overall increase in higher-productivity activities, zone production will have little effect on the structural transformation

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<sup>138</sup> If external economies of scale exist, beneficial externalities, such as knowledge and technology transfers, may be positively linked to the number of firms, or size of the cluster of firms, within the industry in an area.

<sup>139</sup> Marginal productivity of labour should be equal in the different sectors, when resources are allocated optimally (see, e.g., McMillan & Rodrik, 2011).

and economic growth of the economy. It is, however, difficult to ascertain the actual cause of changes in overall employment and what would be happen in the absence of a zone programme. Limited data makes it further problematic. Moreover, an increase in higher-value and higher-productivity production, if it occurs, does not necessarily significantly affect the economy if profit mainly goes to foreign investors, and little technology and knowledge spillovers accrue to the overall economy.

Employment within zones in Africa as a share of total employment is low on average, as seen in table 2.2. Table 2.1 does however show that there are large differences across the SSA region, and both Kenya and Lesotho have been relatively successful in attracting labour-intensive industry when compared to some other African countries, for example, Ghana, Zimbabwe, and Gabon, although, labour-intensive industry in both Kenya and Lesotho has declined, causing employment generation to stagnate. Within the zones, the textile and apparel sector is a major source of domestic formal-sector employment, especially in Lesotho, providing an important source of income for many families who otherwise mainly depend on subsistence farming. Other opportunities for formal sector employment are few in Lesotho, apart from employment in the public sector, and in the mining sector in Lesotho and South Africa. Export of energy, in particular hydropower, provides possibilities for significant foreign exchange revenues, but the potential for employment generation in this sector is small. The zones in Lesotho and Kenya employ about the same number of workers, but employment in the Kenyan zones has had less noteworthy effect on manufacturing employment and total employment. However, although formal-sector employment is heightened, neither of the countries' shares of informal employment or high unemployment rates have been significantly reduced. Informal-sector employment remains the main source of employment, and still provides the main source of employment generation, increasing the share of informal-sector employment in the countries. Even if ambitious targets for employment generation are met, direct employment within the zones will only absorb a small fraction of the number of workers entering the labour force in the coming years. Hence, the findings of these case studies are consistent with the argument made by Kusago and Tzannamos (1998) that the EPZs' potential to solve the problem of unemployment is at best limited. Backward linkages from industry within the EPZs may however substantially increase indirect employment and the effect of zone programmes. The significance of using local intermediate and raw inputs will be further discussed below.

### ***5.2.3.2 Training and Experience as Labour Productivity Improvements***

Although an inflow of capital may significantly increase employment and exports and improve economic growth in the short-term, the long-term effect may be limited. According to neoclassical growth theory, the long-term effect on economic growth depends on improvements in human capital and technological development. Experience, on-the-job training, and training programmes implemented by the employer have the potential to improve workers' skills and labour productivity. However, the production that traditionally has been located in developing countries, including Kenya and Lesotho, has mainly been in need of low-skilled labour, and thus training of workers has often been limited to specific tasks in the production chain. Employment may still make workers accustomed to manufacturing work, as Lall (2005) argues is evident in Lesotho, but may not necessarily provide workers with broader skills that are easily applicable elsewhere, or provide good opportunities for technology and human capital spillovers (see, e.g., Fosfuri et al., 2001). Yet, Kingombe and Te Velde (2013) find evidence that employment within the EPZs has improved labour productivity in Kenya, implying that job experience and training provided by the EPZ firms have a positive long-term effect on the economy. The EPZs' effect on labour's skills and productivity is likely to depend on the type of investments within the zones, suggesting that some types of investments within the EPZs are more valuable, especially in the long term, than others. This aspect should be emphasised by zone authorities when targeting investors, to enhance the possible benefits of zone programmes.

Training and education programmes undertaken by the government have been rather poorly tailored to the needs of the industry and hence inefficient in complementing the industry in Kenya. Training in Lesotho is moreover insufficient, and the government of Lesotho is attempting to enhance investors' incentives to provide training, by making the costs of training tax deductible at 125%. Ultimately, training and an increase in skills and labour productivity will benefit both investors and workers, with subsequent positive effect on economic growth. For the investor, the advantage of such financial incentives is that the skills obtained are likely to be tailored to the needs of the industry. Training programmes implemented by the government may still be important to increase labour productivity and labour competitiveness, and to better ensure technology and knowledge spillovers. Government-supported training facilities also increase overall human capital, and provide local workers with better opportunities to rise to management level and ultimately open their own businesses (see, e.g., Fosfuri et al., 2001; Kusago & Tzannatos, 1998). An increase in skilled labour through training and experience is likely to have a positive effect on wages

within the zones, as firms pay higher wages to secure skilled workers with a positive effect on foreign exchange earnings. The increase in wages is to some extent dependent on the flexibility of the labour market and the existence of other employment opportunities. Higher labour productivity will, however, generally allow the workers to demand higher wages.

### ***5.2.3.3 The Effect of Labour Markets, Wages, and Working Conditions on Employment Gains***

Flexible markets are argued to be critical for zone programmes to attract investors and be successful, by, for example, the World Bank (1992) and ILO (2011), although labour markets are likely to be more important for investors within labour-intensive industry. Countries' labour markets have a potential effect on employment generation: if high costs are associated with hiring and firing employees, firms may find it cost effective to increase the capital intensity of production by improving plants and equipment. The flexibility of the labour market furthermore affects the potential for labour circulation between EPZ firms and local producers, and the possibility for transfers of knowledge and technology from the EPZ firms (see, e.g., Fosfuri et al., 2001). If the labour market is rigid, or few other employment possibilities exist in close proximity, spillovers through labour circulation are less likely to occur. These findings are in line with McMillan and Rodrik's (2011) conclusion that countries with flexible labour markets are more likely to see a structural transformation of the economy with productivity growth. The fact that Kenya has a larger locally owned manufacturing sector outside its zones than does Lesotho, and also possibly less rigid labour markets, might help explain why Farole (2011) finds evidence of significantly greater labour circulation from zones to domestic firms in Kenya than in Lesotho. Low costs associated with hiring and firing workers may, however, also result in poor job security, which must be weighed against the potential benefits. The more rigid labour market in SSA may to some extent explain why SSA zones in Kenya, Ghana, and Lesotho, for example, have a significantly higher share of temporary employees than non-African zones according to Farole (2011). However, other factors such as higher uncertainty linked to trade agreements, future demand, government incentives, and/or political and macroeconomic stability are also plausible factors that may influence the use of temporary employees. The latter factors' effect on investment and employment levels within the zones will be further discussed in the next section.

Low wages and poor working conditions are often the main critique of the zone programmes, though the literature contains disputes over EPZ investors' actual effect on labour standards in the host countries. Their effect on labour standards will differ between countries, depending on labour standards in the local economy, type of investors, level of

competition, monitoring, the unemployment rate, and consumers' demands regarding standards, among other things (see, e.g., Cling et al., 2005). Rational workers should however view themselves as better off working within the zones than in alternative employment.<sup>140</sup> Yet, poor working conditions are a potential source of conflict, with significant social and economic costs, and also have potentially detrimental effect on investments, as pointed out by, e.g., LaRRI (2000). Poor working conditions may also negatively impact workers in the long run, which they may not be able to anticipate or take into account. The long-term benefit of generated employment may significantly decline if workers are exposed to health risks, or other negative factors. It is however difficult for the government to balance workers' welfare and possible future costs of conflict, health risks or environmental degradation, with the desire to become or remain competitive. This is evident especially in Lesotho, though wages within the zones are found to be somewhat higher than minimum wage in both Lesotho and Kenya. Low wages in the textile and apparel industry have caused some tension between workers and employers in Lesotho, and are likely to influence the general opinion of zone programmes.

Reducing wages or keeping minimum wages low can be a relatively inexpensive measure for the government to perform, while improvements in other areas affecting investments, such as labour productivity and infrastructure, may have significantly greater costs, take longer time, and/or be outside government control. This does cause a concern for wages and labour conditions for zone programmes, especially those for whom the main attraction is low labour costs, as argued by, e.g., Wu (2009) and Jauch et al. (1996). Lowering wages are however not expected to impact the zones' competitiveness or investments in the long run. The key to reducing the pressure on wages and working conditions is to improve the zones' overall competitiveness, preferably by improving factors that also have a long-term positive impact on the economy. The government in Lesotho aims to ultimately sell export goods at higher prices, which would allow for higher wages, as consumers put more emphasis on labour and environmental standards. However, this requires consumers being knowledgeable about current working conditions in different countries and being willing to pay higher prices. Working conditions in Lesotho must also be better relative to other countries, while still being fairly competitive, which is not necessarily easily established. The next section will, however, look into factors that may have significant positive effect on both the zones' competitiveness and the prospects of long-term economic growth.

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<sup>140</sup> See, e.g., Warr (1989) and Maloney (2004).

#### **5.2.4 EPZ Programmes to Foster Local Suppliers and Indirect Employment**

Although the significance of linkages between the zones and the domestic economy in enhancing spillovers and increasing the net benefit of zone programmes is widely recognized in the literature, many countries still fail to facilitate noteworthy linkages between the zones and local firms and suppliers (see, e.g., Chinguno, 2009; Jenkins, 2006). This is evident especially in the textile and apparel sector in the case studies. Local suppliers find it difficult to compete with Asian producers, in particular China and India, due lower labour costs and economies of scale in production in these countries. Use of local intermediate and raw materials for this reason remains low, with subsequently small indirect employment generation and foreign exchange earnings. As a consequence, the effect of the programmes remains small in relation to the potential benefits and to the zones' possibly substantial costs. If investors utilize only local labour, and little training or spillovers occur, other types of employment generation programmes may for this reason be more reasonable, as has been argued by Jauch et al. (1996).

Foreign investors may gain from improving the quality of products and efficiency of local suppliers, ultimately increasing the use of local inputs over time. Several empirical studies find support for significant vertical spillovers from FDI (see, e.g., Harrison and Rodriguez-Clare, 2010). The footloose nature that characterizes many EPZ firms, and the opportunity to import raw material and intermediate inputs duty-free, do however to a large extent reduce the incentives for EPZ investors to foster local suppliers, as argued by Farole (2011). According to Jenkins (2006), the likelihood of backward linkages is heightened if firms within the zones are small, well established, capital intensive, partly or fully owned by local investors, and/or sell greater shares of production to the domestic market. Firms with these characteristics are likely to be less footloose and more rooted in the domestic economy. Both an increase in domestic investment and reduced restrictions on domestic sales may also increase backward linkages according to Jenkins (2006). Increases in domestic investments within the zones are being targeted in both Kenya and Lesotho. Domestic expenditure has increased concurrently with domestic investment in Kenya in recent years, though overall investments have also increased. Both governments have also encouraged a more integrated production within the country, by facilitating investments in industries' supply chains, e.g., fabrics and yarn. Financial support or training programmes may also make local producers more efficient and improve the quality of local products, and subsequently increase the competitiveness of local producers.

EPZ programmes may have better prospects for greater backward linkages if they attract industries in which the countries have good prospects of providing local inputs. Kenya has large areas of land suitable for cotton and agricultural production that can support textile and apparel production or the food and agri-processing industry, though food security is a rising challenge in the country according to IFPRI (2013), and the country sees large fluctuations in rainfall. Although cotton production has been low compared to its potential, the textile and apparel value-chain has generated income for a significantly larger number of small-scale farmers than direct employment within the textile and apparel industry. Use of local inputs in the textile and apparel industry is relatively low, suggesting potentially large gains if production becomes more competitive. In Kenya, the increase in nonapparel industry, such as food- and agri-processing, has the potential to significantly enhance backward linkages as the industry sources the majority of inputs locally. Lesotho has, in contrast to Kenya, a more limited capacity to produce cotton without further deteriorating food security in the country, and the mills in Lesotho source the majority of cotton from other African countries. Employment opportunities for small-scale farmers linked to production of raw materials for the industry within the zones are hence limited. Poor potential to grow cotton can explain the lower share of local inputs used in the textile and apparel sector within the zones in Lesotho. Production of intermediate inputs may still increase overall employment, for example in the country's mills. It is evident that the use of local inputs, as well as training, and hence the overall long-term effect of the EPZ programmes depends on the type of FDI the zones are able to attract. Zones that are able to attract higher quality investments, or choose the investors and the type of investments with the largest overall gain, are for this reason likely to have a significantly higher net benefit from the zone programmes. As most SSA zones have considerably lower levels of investment than targeted, the zone authorities may not feel they have the luxury of being too critical. It is however of importance that zone authorities focus on overall economic gains, i.e., overall employment generation over direct employment generation as well as potential for spillovers. A rise in economic activity in the areas surrounding the zones may have a significantly greater impact for a larger number of people in the country than only the number of people employed within the zones. Difficulties measuring the overall effect on the economy and limited available data in many developing countries however makes estimations possibly inaccurate, and easier measures such as direct employment and level of investment are for this reason used to get an indication of the zones' overall effect.



### 5.2.5 EPZ Programmes as a Policy for Industrial Development

Demonstration effects and transfers of technology and knowledge from FDI may ultimately have a significant positive effect on competitive domestic firms, with a subsequent positive effect on overall industrial development, as noted above. EPZ programmes can be a potentially important policy to increase the presence of foreign investors in the country, as further discussed below. Technology and knowledge spillovers may be crucial to prevent a further increase in the productivity gap between SSA and other regions.<sup>141</sup> Ultimately the inflow of FDI will reduce the gap, and allow SSA to ‘catch up’ with developed countries.

Although local investment is relatively high in several African zones, among them Kenya, there is little evidence of a sizeable increase in the number of local globally competitive producers through knowledge and technical spillovers, or demonstration effects, as Easterly (2002) finds evidence of in Bangladesh. This is however consistent with other studies that find few horizontal spillovers from FDI (see, e.g., Aitken & Harrison, 1999; Harrison & Rodriguez-Clare, 2010). It is also in line with Collier and Venables’s (2007) argument that though EPZ programmes may increase industry, they are not necessarily sufficient to stimulate large-scale industrial development. Locally owned manufacturing firms remain few in Lesotho. There are several factors that appear to affect spillovers from foreign investors within the zones. Domestic firms’ ability to absorb knowledge and adopt new technology is one of them. In the short term, the process of learning may impose significant costs on domestic firms, as resources are devoted to learning and to acquire and adopt new technologies and techniques (see, e.g., Liu, 2008). Domestic firms may not necessarily have the incentive or financial ability to focus on the long-term benefits. The government may therefore need to improve the chances for spillovers to occur by giving local firms financial aid or loans in times of transition, improving their ability to finance the process of learning. However, capital is scarce in developing countries, and it may be difficult to establish which firms may ultimately become globally competitive. Firms within desired sectors with significant growth potential need to be targeted, which is the aim of the Kenyan Export Business Accelerator Programme.

The probability of transfers of technology is furthermore likely to be higher when EPZ firms’ profits are not negatively affected by an increase in the number of local competitive firms. Spillovers may be more likely to occur if domestic firms do not compete in the same market, or if competition is weak, if economies of scale exist in the industry, or if profit is

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<sup>141</sup> See, e.g., McMillan and Rodrik (2011).

dependent on collaboration (see, e.g., Fosfuri et al., 2001; Aitken & Harrison, 1999). Transfers of technology may hence increase if domestic and foreign investors are able to complement each other. Joint ventures offer good opportunities for collaboration and linkages between foreign and local investors. A joint venture programme is an important part of KEPZA's strategy in Kenya, though no requirements exist to have local investors to receive EPZ benefits.<sup>142</sup> This is also the case in Lesotho. Most SSA zones do not appear to have the competitiveness or attractiveness to be able to require this from investors, but further benefits for local ventures compared to EPZ firms fully owned by foreigners may induce investors to look for domestic investors to partner with.

Technology and knowledge transfers may for the above reason potentially be greater if local firms serve the domestic market alone, or if price competition in the export market is low. Restrictions on domestic sales remain part of the main attraction of EPZs for many governments. EPZ programmes provide countries with the possibility to slowly increase the competition domestic firms face by increasingly allow greater domestic sales. An increase in competition is likely to increase domestic firms' incentives to improve efficiency and to hence adopt new technology. Low domestic sales also limit forward linkages, and also potentially backward linkages to the domestic economy (see Jenkins, 2006). Domestic manufacturing firms are however likely to be opposed to giving EPZ better access to the domestic market, as seen in Kenya.

### **5.2.6 EPZ Programmes as a Policy for Regional Development**

Foreign investors tend to prefer clusters of economic activity and access to skilled labour, making zone programmes poor tools to generate regional development in disadvantaged areas without substantial investments in infrastructure.<sup>143</sup> Regional development is however still a target for some zone programmes, as with the programmes in Kenya and Lesotho, and many zones are located in areas with otherwise poor employment opportunities. It is evident that zone activity to some degree has generated development in the areas surrounding the EPZs in Kenya, and also Lesotho, but investors in both Kenya and Lesotho tend to locate where large clusters of industry already exist, e.g., in Mombasa and Nairobi in Kenya, and in Maseru and Maputsoe in Lesotho. Other zones have been less successful in attracting investments. Significant investments in overall infrastructure are

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<sup>142</sup> Aitken and Harrison (1999) find evidence that technology spillovers from FDI in Venezuela tend to be entirely internalized by joint ventures.

<sup>143</sup> See, e.g., Kusago and Tzannatos (1998); Jayanthakumaran (2003); and Farole (2011).

needed in both countries to support a greater distribution of zones, as targeted by the zone programmes. This may however cause a substantial increase in the costs of the programmes, which needs to be weighed towards the expected benefits and the alternative tools to use. It is clear that regional development is an important aim for both of the countries. It is crucial for governments to recognize the limitations of FDI and zone programmes, and also to identify the factors necessary for investments to occur to better facilitate investments, and avoid misusing and thus wasting scarce resources. KEPZA has had rather unrealistic or at best highly optimistic targets for foreign investments, exports, local investments, and employment within the zones, as has also been the case with many other SSA zone programmes (see, e.g., LaRRI, 2000; Chinguno, 2009).<sup>144</sup> If few local suppliers or competitive firms are in proximity, locating zones in less-developed areas makes it difficult to ensure linkages with the domestic economy. If a zone's location, on the other hand, provides EPZ investors with proximity to raw or intermediate inputs, the zone programme may potentially encourage a natural agglomeration of industry or clusters by removing some of the obstacles for investments, such as lack of infrastructure and excessive red tape. Table 5.1 summarizes the findings in the case studies linked to the first subquestion.

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<sup>144</sup> KEPZA's strategy report of 2007 was however published prior to the global financial crisis, and followed a period of significant growth in investments, exports, and employment, making high expectations for the subsequent period somewhat understandable.

Table 5.1.

## Expected benefits – Do they materialize?

	Kenya	Lesotho
Increase in exports	The value of zone exports, as well as domestic expenditures, has increased substantially since 2000. In 2012, EPZ exports made up about 8% of total exports. The majority of textile and apparel exports to the US under AGOA are produced within the EPZs.	Textile and apparels exports from the zones constituted 80% of exports in 2005. The share later declined, mainly due to an increase in the export of diamonds, but zone production still constitutes very important foreign exchange earnings.
Export diversity	Manufacturing within the EPZs is small relative to domestic manufacturing sector, but the zones may still have contributed to increasing both diversity and higher-value exports.	Inflows of FDI have ensured that manufacturing exports have become the main export commodity, but exports mainly consist of textile and apparel products to the US. Investment in other types of industry has been limited.
Foreign exchange earnings	Foreign exchange earnings have increased over the years, but earnings are limited due to the tax holiday on profits and duty free imports of inputs.	Textile and apparel exports are the largest source of foreign exchange earnings. Domestic profit from the sector is however low.
Employment generation	EPZ employment currently makes up 13% of manufacturing employment, though only a marginal share of total employment.	Employment within the industrial areas makes up the majority of manufacturing employment, and almost 50% of domestic formal-sector employment. Few other opportunities exist for formal employment beyond the public sector and mining industry in Lesotho and South Africa.
Backward linkages and indirect employment	Use of local inputs is increasing with the change of industry within the zones. Use of local inputs within the textile and apparel sector remains low, though Kenya has the potential to produce both raw and intermediate inputs.	Use of local inputs within the zones is low, due to production being mainly within the textile and apparel sector, where use of local inputs is very low. Potential for production of raw materials, such as cotton, is limited.
Transfer of technology and knowledge	A relatively large manufacturing sector outside the zones and share of domestic investors within the zone together provide potential for spillovers, e.g., through labour circulation. However, little evidence of such transfers exists.	Potential for spillovers is limited, as the number of locally owned manufacturing firms remains low. Financial assistance to local industry and leadership training is critical for the development of domestically owned industry.
Regional development	Economic growth in less developed areas is a goal of the EPZ programme. Most investors do however prefer to locate close to Nairobi and Mombasa because of their good access to international export markets. Restricted sales to the EAC region has further increased the share of investments located in areas close to Mombasa.	The most successful zones are located close to Maseru and Maputsoe. Zones located in less developed areas have been less successful.

### 5.3. EPZ Programmes as a Policy to Increase Investments

#### 5.3.1 Political and Macroeconomic Stability

The other subquestion this thesis explores is the main determinants and obstacles for investments within zones in SSA, and whether EPZ programmes are a good policy to increase FDI to SSA countries and their industrial competitiveness. Political and macroeconomic stability stands as an obvious factor that has affected investments and industrial production levels in both Kenya and Lesotho, including the social and political unrest in Lesotho in the mid-1990s and the postelection violence in Kenya in 2008. These periods also saw high inflation. It is further evident that fluctuations in the exchange rates have had a significant effect on the competitiveness of the countries' industries, through both input and output prices. This is consistent with empirical findings (see, e.g., Woodward & Rolfe, 1993; Cling et al., 2005; Aseidu, 2006). Political stability and good exchange rate management is hence fundamental for the success of zone programmes. Some uncertainty has been linked to the Kenyan election this year, and high levels of corruption also constitute an investment risk, in part because AGOA eligibility depends on good governance and adherence to human rights.<sup>145</sup> In general the political and macroeconomic situation in SSA offers good prospects for an increase in investments, as factors affecting investment risk are improving. Inflation has on average been declining, and average economic growth rate is relatively high, despite poor global economic conditions, although some countries are affected by drought and political instability. A further deterioration of the global economy could potentially have a large effect on economic growth and macroeconomic stability in some counties (see, e.g., IMF, 2012).

Insecurity regarding the continuation of EPZ incentives has affected investments within SSA zones, according to, e.g., LaRRI (2000) and Chinguno (2009). Overall support from labour unions and political opposition may be important for the signalling effect regarding the country's overall attitude to foreign investments, which according to Woodward and Rolfe (1993) is central for inflows of foreign investments. A country's overall attitude toward EPZs is likely to become more positive if wages and working conditions improve within the zones, as this is often the main argument against the use of EPZs. This is however not necessarily straightforward to achieve, due to the extensive pressure on zones to be

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<sup>145</sup> See appendix for more information about the different agreements. Table A1 shows that some SSA countries have been suspended from AGOA and EBA benefits, while others have never benefit, due to political instability and human rights violations.

competitive, as discussed above. A perceived higher risk of investing in SSA zones and insufficient knowledge about the investment climate in SSA countries may be important factors for why many investors have shunned SSA zones. In the western media, the SSA region is frequently portrayed as suffering from poverty and conflict, and often more like a country than a diverse region (Aseidu, 2002).<sup>146</sup> The perception of SSA is changing, and the region currently holds several of the top high-growth countries, as pointed out in the introduction. The region as a whole does however continue “to face the biggest competitiveness challenges of all regions” according to WEF (2013, p. 12). Although SSA EPZ programmes have yet not managed to attract targeted levels of FDI, EPZ policies may still have an important signalling effect about SSA countries’ attitudes towards FDI. EPZ policies hence may somewhat help change investors’ perception of SSA’s investment climate. Confidence about continued preferential market access has moreover a significant effect on investments within the textile and apparel industry in both Kenya and Lesotho. The significance of trade agreements is further discussed below.

### **5.2.2 EPZ Programmes as a Policy to Reduce Production and Trade Costs**

Infrastructure development is argued to be a key for SSA to increase investments and to see a structural transformation of the economy, by, e.g., UNCTAD (2012a). Energy and water security are major problems in many SSA countries, making it difficult for countries to facilitate a significant expansion of the manufacturing sector. The countries also lack capital to be able to ensure large improvements in overall infrastructure. A very favourable aspect of zone programmes is that, to a certain extent, countries can focus infrastructure improvements, such as industrial buildings, water and electricity supply, road network, access to port, and administration, in a limited area and reduce costs of trade and production. This may be more economically feasible for the government to facilitate. However, even though infrastructure within the zones may be noticeably better than that of the domestic economy, it may not necessarily be globally competitive, depending on the overall infrastructure, as argued by Farole (2011). Overall infrastructure in the country determines the base of improvements, as well as the quality of supportive infrastructure and the costs of the programme. More developed countries will hence have lower costs of providing globally competitive infrastructure than less developed countries where larger investments are required.

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<sup>146</sup> Aseidu (2002) finds that a country being African has a significant negative impact on overall FDI, and that an increase in return to capital to have less effect on inflows of FDI than in non-African countries, *ceteris paribus*. Based on these findings Aseidu concludes that investors perceive investments in Africa to be at higher risk.

Infrastructure in the overall economy may moreover affect how easy it is to access local suppliers and how the business environment is perceived. Hence, while limiting infrastructure development to a specific area may offer a place to start, overall infrastructure does affect the programmes' success. More developed countries are likely to have a better general infrastructure, and a higher capacity of government, and, for these reasons, a heightened possibility of ensuring the success of an EPZ programme. Higher unit labour costs might however offset these factors. Lesotho does however demonstrate that poor, small and landlocked countries can have relative successful zone programmes, if circumstances are favourable. The number of EPUs in many African countries, such as in Kenya, may put greater pressure on overall infrastructure, and also potentially reduce external economies of scale. However, rational investors should be expected to settle in areas that are most favourable to them, and the literature does not provide any evidence that the use of EPUs has any effect on zone programmes' success (see, e.g., Rolfe et al., 2004; and Farole, 2011).

Both Kenya and Lesotho offer zone investors access to water and electricity that is superior to that in the domestic economy. Yet, the unreliable supply of electricity and water is still an important obstacle for investments in the zones, together with costs of trade, including high transport costs, the time taken to export and import, and excessive red tape, as seen in the case studies. An increase in manufacturing industry has put significant pressure on both electricity and water supply in the countries, and an increase in industrial activities also requires infrastructure to handle substantial flows of wastewater. Well-developed infrastructure that can ensure waste and wastewater treatment is central to reduce environmental costs of a significant increase in manufacturing activities. Substantial investments in infrastructure are needed in both Kenya and Lesotho; the countries have invited private investors to develop zone infrastructure and to provide services, which can somewhat reduce the governments' expenses linked to zone programmes.

Electricity production is typically linked to economies of scale, which to a degree explains why electricity prices in Kenya are relatively high when compared to other African countries, such as South Africa and Egypt. Lesotho has managed to significantly improve electricity supply within its zones, in part by prioritizing electricity supply to industrial areas. Such prioritization reduces the need for improvements in capacity, as the industry's cost of power outages are reduced. Nonindustrial areas may on the other hand be negatively affected. Due to high production costs, electricity in many SSA countries may be underpriced, which can impose great costs on the government while foreign investors benefit. Yet, electricity provided at a higher cost affects the competitiveness of manufacturing industry in SSA, and

can impede the development of the larger manufacturing sector. Pooling the supply of electricity between African countries may considerably reduce instability in supply and production costs. Such a regional cooperation does however require substantial investments in infrastructure over time (see, e.g., Collier & Venables, 2009). The government of Lesotho has together with the government of South Africa made substantial investments in a water and hydropower project that should significantly improve electricity supply in Lesotho.

Zone programmes can potentially have a substantial effect on a country's logistics performance with subsequent effect on trade costs, as many programmes establish simplified procedures linked to starting a business, and to exporting and importing. An EPZ programme may hence be a central way to improve the ease of doing business and as such enhance the host country's attractiveness to foreign investors. According to Nunn (2007), soft infrastructure, such as the juridical system, is critical to explain global production and trade patterns. Improvements in overall infrastructure may however be needed to see substantial effects on investment and trade. Infrastructure that ensures good access from the industry to port facilities and a well-functioning port may further significantly reduce costs of trade, and have a positive effect on investment levels (see, e.g., Arvis et al., 2013).

SSA does not have the advantage of being close to large markets, and distance may significantly increase trade costs. However, the success of zones in South Asia, East Asia, and Mauritius show that geographical location is not necessarily an obstacle for SSA zones to succeed. SSA's 16 landlocked countries may, however, find it difficult to attract production that can locate anywhere, if their lack of a port induces a further increase in costs of trade. This relies on infrastructure in the country itself and its neighbours. Industry in Lesotho gains by access to South African ports, which is well developed, compared to other SSA countries. Distance to the ports may however cause a disadvantage to industry located in closer proximity to same-quality ports. Furthermore, barriers to trade are not utterly in the control of Lesotho's government, as South African ports' capacity and efficiency, and the performance of South African customs services, affects the time taken to export and import to the country.

To realise an increase in investments it is imperative that governments attend to the factors that are in reality hampering investments. If several obstacles exist, they might need to be removed simultaneously to see a notable improvement in zone investment, which may require considerable investments by the government. However, several measures that will enhance the possibility of successful EPZs will also have a positive effect on the overall economy, such as reduced red tape, improved business environment and institutions, and macroeconomic and political stability. Measures, such as reducing wages and lowering taxes,



on the other hand, though relatively inexpensive for the government to execute, may neither have a notable effect on investments within the zones nor the overall economy, above all in the long run.

### 5.2.3 The Effect of Regional Trade Unions in SSA on EPZ Programmes

The size of local and regional markets is positively correlated with levels of investments, employment, and exports within and from the zones, and with FDI to the overall economy (Farole, 2011; Aseidu, 2006). However, as noted above, one of the perceived benefits of EPZs is that they allow the country to liberalise trade in just one limited area. Local markets in SSA are also often too small in both size and income to attract market-seeking foreign investment (see, i.e., Rolfe et al., 2004; Aseidu, 2006). This may explain low domestic sales from zones in both Kenya and Lesotho.<sup>147</sup> Although, if SSA countries continue to see significant positive economic growth Kenya and Lesotho may both constitute arenas to enter the rapidly growing market. Regional trade agreements and customs unions can potentially increase the size of the domestic market. However, if domestic sales are restricted, such an increase will not benefit EPZ investors and may require them to find new markets, as was the case in Kenya. Restrictions on domestic sales from EPZ firms are a heated topic in Kenya, where, although EPZ sales to countries within the EAC are restricted, the government targets an increase in regional sales from EPZ firms.<sup>148</sup> The East African region is already an important destination for the country's manufacturing exports. EPZ firms often have an advantage over local firms due to their size and international relations, and the incentives given to EPZ firms may put local firms at an even greater disadvantage. A central argument against allowing greater domestic sales is the fear that foreign firms may potentially crowd out domestic firms. This is also one of the main critiques of policies that aim to facilitate the inflow of FDI in the overall economy. This concern is however likely to be eased with an increase in the level of domestic investments within the zones. However, fewer restrictions on domestic sales may multiply the number of existing domestic firms eligible for EPZ status, which may significantly reduce the government's tax income. Moreover an overall trade liberalisation may be easier to facilitate. Domestic sales from the zones are often less restrictive today than earlier, but the long-term effect of domestic sales on long-term

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<sup>147</sup> Lesotho does not restrict domestic sales, though profit from sales within SACU is subject to a 10% tax rate. Sales to South Africa have seen a significant growth in recent years, but as the Lesotho's market is small both in terms of population and in purchasing power, domestic sales can be expected to remain low.

<sup>148</sup> See, e.g., Omondi (2013).

economic growth is disputed in the literature. An increase in regional trade is central in many SSA countries' development plans, including Kenya and Lesotho, and governments need to ensure that EPZs' policies harmonize with regional trade agreements for zone programmes to be most efficient.

#### **5.3.4 The Significance of Trade Preferences for Investments within SSA's EPZs**

The existing textile and apparel industry in both Kenya and Lesotho, and government incentives, such as the EPZ programmes, appear to have been essential in allowing both countries to take better advantage of the AGOA. These factors may also explain why the opportunities given by the AGOA have had a greater effect in these countries relative to many other SSA countries, especially in textile and apparel production (see, e.g., Collier & Venables, 2007). The end of the MFA and poor global demand has to some extent later eliminated the significant increase in production both Kenya and Lesotho saw following the initiation of AGOA. Yet, continued duty-free and quota-free market access to the US appears vital to sustain the textile and apparel sector in both countries. The exemption to the rule of origin and the third-party fabric provision under AGOA do moreover need to be continued for export levels to maintain, as neither of the countries are yet able to produce competitive inputs.

It is evident that trade agreements can have substantial impact on production and trade patterns. Preferential market access improves eligible countries' relative competitiveness, depending on the number of countries given beneficial access. The LNDC for this reason expressed concern for Lesotho's textile and apparel production when Mauritius was exempted from the rule of origin under AGOA in 2008. Zone production that is dependent on preferential trade agreements remains somewhat vulnerable. The uncertainty linked to the continued exemption to the rule of origin under AGOA and the trade agreement itself, and hence access to the US market, has had a notable effect on investment levels in zones. This is especially evident in Lesotho at the end of every exemption period, as demonstrated in the case studies. The rule of origin has, however, also put pressure on the countries to attempt to build a broader industry and increase backward linkages, and to some extent enhance regional trade. Although integrated textile and apparel production in African countries may be the ultimate target, the possibility for it to come about in the short run is small, and for this reason the potential for an increase in textile and apparel exports to the EU even with the EBA

remains low.<sup>149</sup> Trade agreements that are applicable for longer periods may reduce fluctuations in investments some and facilitate more long-term investments, including in the overall supply chain, with larger positive spillovers. Such trade agreement(s) may also better achieve the aim of facilitating economic growth in one of the poorest regions in the world.

### **5.3.5 SSA Countries' Ability to Facilitate Labour-Intensive Industry**

The traditional EPZ model allows developing countries to take advantage of their surplus labour, while giving firms the possibility of significantly reducing their labour costs. Many SSA countries have been found to have high labour costs relative to labour productivity, causing unit labour cost to be uncompetitive with many non-African countries, such as China, India, and Bangladesh (see, e.g., Farole 2011; Clarke, 2012, Cling et al., 2005).<sup>150</sup> High living costs make it difficult for many SSA countries to reduce wages to improve competitiveness in labour-intensive industry. Such low competitiveness was illustrated in the case studies by the sizeable effect of the end of the MFA, even when given duty-free and quota-free market access. While EPZ incentives and trade preferences have fostered a textile and apparel industry with important direct and indirect employment, it has yet to become competitive. A relative increase in labour costs in other regions following economic development, or an increase in economies of scale in SSA, which could potentially be facilitated by EPZ programmes, may improve SSA competitiveness in labour-intensive industry, but this has yet to occur.

Several scholars argue that SSA countries with large endowments of natural resources might have a better possibility to develop a competitive advantage in industry that takes advantage of natural resources than in labour-intensive industry (see, e.g., Farole, 2011; Dihn et al., 2012). Kenya has slowly seen an increase in nontextile industries within the zones after the end of the MFA. The textile and apparel industry is still the largest industry and the main source of employment within the zones. The increase in other types of sectors, such as the food- and agri-processing sector, does however potentially provide better opportunities to develop a competitive industry, also regardless of trade preferences. Lesotho has on the other

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<sup>149</sup> As the UN does not classify Kenya as an LDC, exports from Kenya do not have duty-free and quota-free access to the EU. Kenya is, as a developing country, still given lower duties on exports to the EU market through the EU's Generalised Scheme of Preferences (European Commission (EC), 2013a, 2013b).

<sup>150</sup> Labour unit costs are not a perfect measurement of the competitiveness of labour. Labour productivity are often measured using value-added per worker, and may be estimated rather high in many SSA countries as many local firms meet relative low competition. The use of capital and its effect on labour productivity is furthermore not included. The measurement does however give a useful indication of the competitiveness of labour in SSA countries (see, e.g., Clarke, 2012).

hand fewer natural resources and less land suitable for agricultural production, and its prospects for significantly increasing agricultural production to support a larger food- and agri-processing sector, or support industry based on natural resources, are hence poorer. Opportunities within industries such as water bottling and sandstone processing are promoted by the LNDC, but investment levels within these industries remain low, and most food-processing and beverage firms in the industrial areas remain partially or fully owned by the government. However, Lesotho has good prospects for sourcing inputs to food and agri-processing industry regionally, and to facilitate such regional trade and production chains, as has been the case in yarn and fabric production in the country. Beneficial trade agreements, such as the EBA agreement and the AGOA, allow a range of goods duty-free and quota-free, but most SSA countries, including Kenya and Lesotho, only produce and export a few of these. Opportunities exist for SSA countries to take better advantage of these possible goods, regional inputs, and trade and production chains.

EPZ industries based on natural resources may however be poor tools for employment generation, as these activities are often more capital-intensive, with consequently smaller direct-employment generation within the industry relative to the level of investments. Ghana's zone programme has for example seen substantially higher investment levels within the country's zones compared to other SSA countries, including Kenya and Lesotho, but employment creation has been relatively limited as most investments are related to processing of the countries' resources (Farole, 2011; Boyenge, 2007). Natural resource processing, as an industry, may however be more stable, as it is dependent on a more location-specific resource than labour, and may also generate higher indirect employment due to greater use of local inputs, as discussed above. Proximity to natural resources may also provide a more sustainable source of competitiveness and potentially provide SSA countries with an advantage, ultimately reducing the pressure on wages, and as a consequence increasing value added in production (see, e.g., Sargent & Matthews, 2004). Unsustainable incentives and the race-to-the-bottom dilemma are the main weaknesses argued to be associated with EPZ programmes based on traditional incentives. If a country lacks any advantage compared to other countries with similar zone programmes, or is unable to develop one, zone programmes are more likely to only facilitate production of standardized low-value-added products, and for this reason are less likely to enhance structural transformation with higher-value production or foreign exchange earnings (see, e.g., Romer, 1998; Sargent & Matthews, 2004; Kaplinsky, 1993). EPZ programmes should for this reason target investments within industry where the country has good possibilities for becoming increasingly competitive, ultimately by

having a comparative advantage in production. The desperate need for employment generation may however yet induce the government to target labour-intensive industry. Table 5.2 summarises the findings in the case studies linked to the second subquestion.

Table 5.2.

## Obstacles to investment within the zones in Kenya and Lesotho

	Kenya	Lesotho
Overall business environment	Kenya is the trade and financial hub in East Africa. The country's competitiveness and ease of doing business is ranked relatively low, but Kenya is still among the top countries in SSA on both indices. Improved global competitiveness is one of main targets in the country's development plan.	The country's competitiveness and ease of doing business is ranked very low, also compared to many other SSA countries.
Unit labour costs	Unit labour costs are high compared to Asian competitors, such as China, India, and Bangladesh, but low relative to many other SSA countries with similar programmes.	Labour unit costs are high relative to Asian competitors. Studies dispute how such costs compare with other SSA countries.
Electricity supply	The electricity supply is relatively well developed, but expensive compared to prices in Asia and larger countries in the region, such as Egypt and South Africa.	Lesotho's electricity supply is relatively good, especially compared to countries with similar levels of income. Supply of electricity to the industry is prioritised.
Water supply	Large fluctuations in water supply cause challenges for industry, also within zones.	Water supply is relatively good and stable.
Port infrastructure	The capacity of the port of Mombasa is relatively good compared to many other SSA countries, but capacity and efficiency still need to be improved.	The country is landlocked, but benefits from access to South African ports, which is good compared to other SSA zones.
Railway and road infrastructure	Poor roads and railways hamper investments within the zones. Zones close to Mombasa, which has better access to global markets, appear most attractive to investors.	Railway and road infrastructure are relatively poor, and improvements are needed. Zones located in proximity to the largest cities are for this reason preferred by investors.
Red tape	Reduced red tape is likely to have significant impact on investments and trade within the zones, and the country overall. Corruption is perceived as one of the largest obstacles for business.	Reduced red tape linked to investing, exporting and importing is expected to have a positive impact on trade and investments. Corruption remains among the greatest constraints for business, along with access to finance.
Timing	The first EPZs were established in 1990, prior to the initiation of AGOA and the end of the MFA. This is likely to have had a significant positive impact on investments.	The industrial areas were established prior to most similar zones in SSA, and ties with early settled Asian investors have been crucial for further investments.
Location	The country is the East African trade hub, with good connections to neighbouring countries by air and road. EPZ firms do however currently mainly produce to markets outside SSA.	The country is landlocked, but has access to South Africa's infrastructure. Lesotho hence has relative good access to global markets to many other SSA countries. SACU constitute an increasingly important market for exports.
Political and macroeconomic stability	There have been incidents of political and macroeconomic instability. The country is relatively stable now, but insecurity has been linked to the election in 2013 and high levels of corruption.	Currently stable, though there have been incidents of political and macroeconomic instability with notable effect on investments.
Trade agreements	The textile and apparel sector within the zones benefited greatly of the initiation of AGOA in 2000, but investments and employment levels declined some again following the end of the MFA.	Production and employment within the textile and apparel sector saw a notable increase with the initiation of AGOA in 2000, but production and employment later declined, despite measures by the government to maintain investments.

## 5.4 Summary and Conclusions

Regardless of the zone programmes' questionable impact as found in the literature, especially in SSA, many African governments have initiated and/or remained committed to their EPZ programmes. The number of zone programmes in SSA has consequently seen a noteworthy growth. Large investments are most often required to develop and support zone programmes, as good quality infrastructure is needed to attract investors. The success of the zones and the return on the investments are however uncertain. Many SSA zones have low investments and employment levels, which suggests that the zones are not large enough to provide the expected benefits; to have a significant effect on export earnings, economic diversity, or employment growth; or to contribute to a structural transformation of the economy. However, as many SSA countries are characterized by low levels of formal employment, and depend on subsistence agriculture and exports earnings from natural resources, the introduction of nontraditional industry (or services) may still have a potentially notable effect on the economy.

The relatively low levels of investment in many of SSA's zone programmes are explained by factors such as poor overall investment climate, poor infrastructure, and high levels of corruption. The timing of the programmes' launch, the existing large clusters of industrial activity, and regional supply chains elsewhere furthermore put many SSA countries at a disadvantage due to the lack of economies of scale. Low global demand in recent years may also help explain small inflows of FDI. Scarcity of skilled workers and unfavourable labour unit costs further hamper SSA's competitiveness in labour-intensive industries, which typically have located within EPZs globally. The perceived risk of investing in SSA zones may also be relatively high, due to frequent policy changes and the political and economic instability in some countries. Uncertainties linked to continued preferential market access are also likely to have a significant negative impact on the level of investments within the SSA zone programmes, especially in labour-intensive industries where SSA competitiveness is comparatively low. Furthermore, though EPZ programmes may significantly improve infrastructure in a specific area, and as such facilitate trade, overall infrastructure in the countries still have effects on trade and production costs, and hence investments. More developed SSA countries are for this reason more likely to be able to foster successful zone programmes, and EPZ programmes are a poor tool to generate economic growth in the

poorest countries. Yet, the case study of Lesotho shows that also small, poor and landlocked countries can foster relative successful programmes if circumstances are right.

The size of the zones does not alone determine their effect: vertical or horizontal linkages between EPZ firms and the domestic economy determine the potential for technology and knowledge spillovers, and decide the overall long-term effect on the economy. One of the main factors causing zone programmes to fail to have an overall positive effect on the domestic economy is that the zones are merely enclaves without linkages to the domestic economy. Direct employment and foreign exchange earnings alone may not cover the significant costs of the zone programme. It is crucial that the zones are integrated in the domestic economy to ensure use of local inputs, labour circulation, training and education facilities which provide tailored skills for the industry, and for knowledge and technology to transfer to domestic producers. EPZ programmes should to a greater extent target investors that will be likely to have great positive effect on the overall host economy. Ultimately, spillovers from FDI within the zones have the potential to boost domestic economic activity, and increase the quality and efficiency of local suppliers, foster local firms that can be globally competitive, and have a positive effect on labourers' skills and productivity.

The significant growth in the number of countries offering similar incentives to investors increases the pressure on countries to stand out and offer the most alluring incentives. This may substantially increase the costs of the incentive packages necessary to satisfy investors, and consequently the opportunity costs of the programmes. It also becomes more difficult to extract shares of zone investors' profits with the growing number of alternative locations for investors. The possible net benefits of zone programmes are hence expected to decline with the number of zone programmes, in particular if countries are not able to build an advantage over other countries. Many SSA countries may be more likely to build a comparative advantage in more capital-intensive industries that take advantage of a country's natural resource wealth. Such industries may also be more likely to increase value added in production, if competition from non-African countries is lower. The potential for direct employment generation from these types of industry is however smaller. Indirect employment, through the production of raw and intermediate inputs, is on the other hand often higher, as seen in Kenya and Lesotho, causing overall employment and income generation to potentially be greater.

Though EPZ programmes are not alone sufficient to increase investments, tax incentives and subsidized infrastructure may still be important for SSA countries to receive heightened shares of FDI, especially within nontraditional sectors. SSA EPZ programmes



have contributed to increasing their countries' ability to utilize preferential trade agreements, such as the AGOA. Preferential market access to the US and the EU has at the same time been essential to facilitate production within many SSA zones, and remains crucial to preserve the level of production in many SSA EPZs, such as the production of textiles and apparels. However, although AGOA has had a substantial effect on investments, further investments within AGOA have been somewhat hampered by the short periods during which the agreement is applicable, as seen in the case studies. The effect of the EBA has furthermore been limited for processed exports, especially textile and apparel production, due to a strict rule of origin for all countries. Special market access and EPZ incentives are intended to ultimately help African countries foster economies of scale. However, for now, industry in many SSA EPZs, including Kenya and Lesotho, provides some employment opportunities but few linkages to the domestic economy; knowledge and technology transfers are therefore limited. Trade agreements with longer time frames may encourage more stable investments with greater backward linkages, and result in a larger long-term effect on economic growth. Yet, trade agreements and zone programmes, even though perceived as successful, have their limitations, and are not alone a solution for economic development and structural change in SSA. Factors such as macroeconomic and political stability, the competitiveness of the exchange rate, overall infrastructure and institutions, corruption, trade costs, and labour unit costs, are essential for both foreign and domestic investment, and impact the economic growth in SSA in the long-term.

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## Appendix

### **The Multi-Fibre Arrangement (MFA)**

Textile and apparel exports from many developing countries were in the period 1974–2005 subject to quota regulations by the major importing countries, through the Multi-Fibre Arrangement (MFA). The aim of the regulations was to protect the textile and apparel industry in developed countries by allowing them to adjust to the significant increase in textile and apparel products from low-cost countries. The poorest countries were exempted from the regulations and several countries benefited from a surge of textile and apparel production, as production was moved to circumvent the quotas, e.g., in Bangladesh (see, e.g., Easterly, 2002). The quotas were negotiated bilaterally. The MFA departed from the basic General Agreement on Tariffs and Trade (GATT) rules, and in the Uruguay Round it was decided that the quotas set by the MFA should be phased out through the WTO Agreement on Textiles and Clothing (ATC). The ATC came into effect on 1 January 1995 (WTO, 2013).

### **The African Growth and Opportunity Act (AGOA)**

The AGOA was initiated in 2000, and aims to offer selected SSA countries duty-free and quota-free access to the US market for certain goods. The agreement is to encourage greater trade and investment in SSA. Countries have to meet government and human rights requirements to be eligible for AGOA benefits, and to take measures to improve the rule of law, human rights, and labour standards. Thirty-four countries were eligible for AGOA benefits in 2000 (AGOA info, 2013). Some countries have become eligible for AGOA benefits following 2000, as these factors have been improved, while other have lost eligibility due to changing conditions, such as political turmoil or failure to meet political and democratic rights (see, e.g., Frazer and Briesebroeck, 2010). AGOA benefits currently apply to 39 SSA countries (see table A1). The AGOA builds on the Generalized System of Preferences (GSP), and gives preferential access for about 1,800 items, including textile and apparel products, to eligible countries to the US market in addition to the about 5,000 items given access under the US GSP. For comparison, 127 developing countries are eligible for US GSP benefits (AGOA info, 2013).

For textile and apparel exports it is required that yarn or fabric used in production must be made in either the US or in an African country for the finished good to be eligible for

AGOA. The rules of origin are to ensure that goods are not merely routed through eligible countries, but contribute to employment and the intended economic effect in the countries. However, AGOA distinguishes between two groups of African countries: less-developed countries (LDCs) in SSA and other SSA countries. Countries categorised as LDC, that is countries with a 1998 per capita GNP less than 1,500 dollars, based on World Bank data, were initially exempted from the rule of origin, or given a third-country fabric provision, through the end of 2004, and allowed to source fabric from non-African countries. The third-party fabric provision was later extended to 2012 and then to 2015. The aim is to give LDCs the opportunity to develop local raw and intermediate materials. Currently South Africa, Gabon, and the Seychelles are the only eligible countries not categorised as LDCs, and hence have to follow the rule of origin. The extension of AGOA up to 2019 is contingent on a successful conclusion to the WTO Doha Development Agenda Round of Negotiations before the end of 2015. The different amendments to the AGOA legislation can be found in Bill H.R. 4101 (AGOA info, 2013).

### **Everything but Arms and the Cotonou Agreement**

The Everything but Arms (EBA) agreement was initiated in 2001, and gives LDCs, according to UN classifications, duty-free access to the European Union market. The agreement builds on the generalised system of preferences system for the EU. In 2011, 49 LDC countries benefited from the agreement, including 33 SSA countries, which can be found in the table below, and 16 non-SSA countries (EC, 2013a, 2013b). In contrast with AGOA, EBA's rule of origin applies to textile and apparel exports also from LDCs, which has resulted in the EBA having significantly less effect on textile and apparel exports to Europe (see, e.g., Portugal-Perez, 2008). If or when countries exit the group of LCDs, EBA preferences are seen as no longer required and EBA preferences stop being applicable after a transition period of three years (EC, 2013a, 2013b). The EU also has an economic partnership agreement (EPA) with African, Caribbean, and Pacific Countries (ACP) based on the Cotonou Agreement. Seventy-nine ACP countries signed the Cotonou partnership agreement in 2000. The EPA is a reciprocal trade agreement, but LDCs of the ACP countries, are not required to open up their market and instead can sell their goods through the EBA (EC, 2013a, 2013b).



Table A1.  
Beneficiaries of AGOA and EBA

	AGO A	EBA (in 2011)		AGO A	EBA (in 2011)
Angola	X	X	Malawi	X	X
Benin	X	X	Mali		X
Botswana	X		Mauritania	X	X
Burkina Faso	X	X	Mauritius	X	
Burundi	X	X	Mozambique	X	
Cameroon	X		Namibia	X	
Cape Verde	X		Niger	X	X
Central African Republic		X	Nigeria	X	
Chad	X	X	Rwanda	X	X
Comoros	X	X	Sao Tome and Principe	X	X
Congo, Dem. Rep.	Suspended	X	Senegal	X	X
Congo, Rep.	X		Seychelles	X*	
Cote d'Ivoire	X		Sierra Leone	X	X
Eritrea		X	Somalia		X
Ethiopia	X	X	South Africa	X*	
Gabon	X	X*	South Sudan		
Gambia	X	X	Sudan		X
Ghana	X		Swaziland	X	
Guinea	X	X	Tanzania	X	X
Guinea-Bissau	Suspended	X	Togo	X	X
Kenya	X		Uganda	X	X
Lesotho	X	X	Zambia	X	X
Liberia	X	X	Zimbabwe		
Madagascar	Suspended	X			

Source: AGOA info (2013); EC (2013a, 2013b)

Table A2.

## Incentives given by the Kenyan EPZ programme

A 10-year corporate income tax holiday, followed by a tax rate of 25%.	EPZ commercial enterprises, such as regional distribution centres, order taking and repacking, and bulk-breaking, have an unlimited tax holiday, but are not allowed to sell any goods and services on the domestic market.
Ten-year withholding tax holiday.	This advantage applies to dividends and other remittances to nonresident parties.
Investors are given perpetual exemption from VAT and customs import duty on inputs.	This applies to raw materials, machinery, office equipment, certain petroleum fuel (e.g., for generators), building materials needed for housing, and other supplies. VAT exemption also applies to local purchases of goods and services supplied by companies in the Kenyan customs territory or domestic market.
Investors are given a permanent exemption from payment of stamp duty on legal instruments.	
New investment in EPZ buildings and machinery (should be applicable over 20 years) are subject to a 100% investment deduction.	
EPZ investors are to only need one license issued by KEPZA to be able to set up and operate EPZ projects.	EPZ investors are hence exempted from various laws in Kenya, such as the Import, Export and Essential Supplies Act, the Standards Act, the Industrial Registration Act, the Factories Act, and the Statistics Act.
KEPZA is to provide project approval and licensing within 30 days.	Projects requiring environmental license may take longer.
EPZ investors meet no exchange controls and the authority facilitates repatriation of capital and profits.	EPZ investors are also given access to foreign currency accounts, and allowed domestic and offshore borrowing.
KEPZA does not require local shareholders in EPZ investments.	
'One-stop shop' service is available.	KEPZA provides assistance to EPZ companies in the areas of staff recruitment, labour regulations, work permits, import-export logistics, application for utility connections, registration with tax authorities, etc.
KEPZA provides serviced land and factory buildings.	Buildings are available for sale or lease to licensed EPZ companies. Utilities, such as electricity, water and waste handling, are offered, together with 24-hour security.
Office premises and storage warehouses are available for lease in most zones.	

Source: KEPZA (2013)

Table A3.

Business environment indicators, from 2007 enterprise survey by the World Bank

	Kenya	Sub-Saharan Africa	Low income
Percentage of firms identifying corruption as a major constraint	38.3	30.0	31.7
Percentage of firms identifying access to finance/costs as a major constraint	41.8	47.9	43.6
Percentage of firms identifying transport as a major constraint	30.6	23.9	21.9
Percentage of firms identifying electricity as a major constraint	27.6	48.1	48.8
Value lost due to power outages (% of sale)	6.4	5.9	6.8
Percentage of firms identifying customs and trade regulations as a major constraint	23.6	19.6	19.1
Average time to clear imports from customs	12.0	9.1	10.8
Average time to clear direct exports through customs	5.6	5.4	6.1
Percentage of firms identifying labour regulations as a major constraint	4.3	9.3	6.6
Percentage of firms identifying crime, theft and disorder as a major constraint	33.1	23.6	20.2

Source: World Bank (2007)

Table A4.

## The main incentives given for manufacturing firms in Lesotho

Manufacturing profit generated from exporting manufactured goods outside of the Southern African Customs Union (SACU) are subject to a 0% corporate tax.	A manufacturing corporate tax rate of up to 10% applies to profits from sales within the SACU region.
A VAT rate of 0% for raw materials intended for export products sold outside SACU.	A VAT rate of 14% on raw materials used in production sold within the SACU, which ensures harmonization with the RSA. The Lesotho Revenue Authority has introduced flexible VAT payment systems, to tax compliant firms, to ease cash flows.
No withholding tax on dividends to neither local nor foreign shareholders.	
Costs induced by giving training to the staff are allowable at 125% for tax purposes.	Payments made for external management skills and royalties related to manufacturing operations are subject to withholding tax of 10%.
The LNDC is to facilitate easy repatriation of manufacturing profits.	
Investors can lease serviced land, and industrial and commercial building from the LNDC.	Foreigners are not allowed to own land in Lesotho.
A one-stop-shop for red tape.	LNDC is to offer investors the possibility to only deal with one office for all administrative procedures, such as permits and licenses.

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Source: LNDC (2013)

Table A5.

Business environment indicators, from 2009 Enterprise survey by the World Bank

	<b>Lesotho</b>	<b>Sub-Saharan Africa</b>	<b>Low income</b>
Number of power outages in a typical month	6.8	10.3	7.9
Value lost due to power outages (% of sales)	6.7	5.8	4.8
Number of water shortages in a typical month	2.5	7.2	6.5
Security costs (% of sales)	4.2	1.8	1.7
Percentage of firms that use email to communicate with clients/suppliers	44.3	44.0	58.3
Days to obtain import license	4.0	19.2	19.6
Average time to clear imports from customs	4.4	12.8	13.0
Average time to clear direct exports through customs	5.4	6.5	6.9
Percentage of firms believing the court system is fair, impartial, and uncorrupted	33.2	43.3	39.2
Percentage of firms feel it is expected of them to give gifts to secure government contract	26.4	38.3	26.3

Source: World Bank (2009)