

Industrialization and Development in Kenya: The Case of Export Processing Zones

By
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Abstract

The lack of industrialization in Sub-Saharan Africa (SSA) is a significant challenge that needs to be addressed in order to achieve long-term sustainable growth and development in the region. Few countries in the world have made significant progress in social and economic development without implementing an effective industrial strategy. Many countries in SSA have created Export Processing Zones (EPZs) in an attempt to address the challenge of industrialization and foster an export oriented manufacturing sector. The Kenyan government's stated objectives of EPZs are to create jobs, diversify and expand exports, increase productive investments, foster technology transfer and create backward linkages between the zones and the domestic economy. This thesis uses the case of EPZs in Kenya to determine if they are meeting these objectives. The thesis argues that in its current form the EPZ program in Kenya is failing to achieve the objectives that it was intended to achieve. Data from the Kenyan EPZs from 2002-2009 shows that there are significant shortcomings in expansion and diversification of exports, linkages between domestic and EPZ firms, and stable full-time job creation. The thesis concludes by offering some recommendations for a more effective industrial strategy that places more emphasis on domestic industry and allows for greater state-led policies to meet economic development objectives.

May 20, 2011

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Chapter 1

Introduction

Since the 1960s, when many countries in SSA achieved independence, much emphasis has been placed on industrialization as a way to achieve economic development. Industrialization and economic development are closely linked. There are few countries that have achieved significant progress in economic development without moving from an agrarian-based economy to an industrial economy. Early development scholars argued that few if any poor countries would improve their living conditions without industrializing; in 1955 Hollis Chenery, a renowned development scholar, wrote that, “Industrialization is the main hope of most poor countries trying to increase their levels of income” (Chenery 1955: 40). Today most development experts would still agree with Chenery. Although there are contested notions of development, some of the most widely accepted development indicators such as life expectancy, infant mortality, literacy levels, and per-capita income generally improve as a country industrializes. The most ‘developed’ countries, according to development indicators such as the human development index (HDI), have at some point gone through a process of significant industrialization.

With the exception of South Africa and Zimbabwe, the majority of countries in Sub-Saharan Africa (SSA) have struggled to achieve significant levels of industrialization. It is one of the greatest development challenges in the region. In 2005 SSA accounted for 0.7% of global value-added manufacturing and excluding South Africa it accounted for only 0.3% of global value-added manufacturing (UNIDO 2009:

Table 9.1). Many countries in the region have instituted various policies to try to spur industrialization; the creation of EPZs is one such policy implemented by a number of countries in SSA. Currently there are over 90 EPZ's in Sub-Saharan Africa, employing over 800,000 people (ILO 2007).

The government of Kenya promotes Export Processing Zones (EPZs) as a key tool in meeting economic development objectives. The government suggests that EPZs will improve economic development outcomes by increasing the export of manufactured goods, creating a larger value-added domestic manufacturing industry, and increasing formal sector employment. The government of Kenya has made EPZs, and their planned transition into Special Economic Zones (SEZs), a central component of its development strategy to make Kenya a middle-income country by the year 2030. The rationale for creating EPZs is that it will attract foreign direct investment (FDI) due to generous tax breaks, competitive labour costs, and other incentives. According to the EPZ supporters, the foreign investors will initially produce labour intensive goods for export and stimulate the domestic manufacturing sector by using domestic inputs; eventually the EPZs will transition into producing higher value and more capital intensive goods as the labour force becomes more productive. Furthermore, the government suggests that domestic manufacturers will become more efficient and sophisticated by their exposure to manufacturing techniques in the EPZ.

However, development scholars, trade unionists, and civil society organizations criticize the effectiveness of EPZs in meeting development objectives. One of the central arguments used in contesting EPZs is that FDI in EPZs will relocate to a lower cost

country with more generous incentives and cheaper labour when the opportunity presents itself, effectively nullifying the objective of increasing value-added exports. Another argument against EPZs, on a more structural level, is that the export-oriented design of EPZs is incapable of stimulating the domestic manufacturing sector to play a greater role in meeting domestic needs and reducing reliance on imports because the inputs are not locally produced. From a labour perspective, the EPZ model is criticized by trade unions and labour rights organizations for creating poor quality jobs that pay low wages and are often insecure because the goods that are produced require little skill and are labour intensive. Given these critiques, this thesis will attempt to determine if Kenyan EPZs are leading to a form of industrialization that will meet domestic needs by increasing and diversifying exports, strengthening domestic manufacturers through backward linkages, and creating full-time formal sector employment.

Literature Review

This section of the thesis examines a variety of literature in an effort to determine which models of industrialization have been most successful in meeting the objectives of increased exports and diversification of manufactured products, strengthening of the domestic manufacturing sector, and increased and better quality employment in the formal sector. There is no standard model of industrialization that is suitable for all countries, but there are some general concepts, based on the experience of other recently industrialized developing countries, that are useful for developing countries seeking to implement an effective industrialization strategy.

The first industrialization model that will be analyzed is Import Substituting Industrialization (ISI). The second industrialization model that will be examined is Export Oriented Industrialization (EOI). The purpose of analyzing these two industrialization strategies is that they have both been implemented in a variety of developing countries with varying degrees of success and these theories have directly influenced the debate on the development potential of EPZs.

In addition to analyzing ISI and EOI, the literature review also explores the industrialization strategies associated with the developmental state model of the Newly Industrializing Countries (NICs) such as South Korea, Taiwan, and Hong Kong. These countries have achieved many of the industrialization objectives that are being evaluated in this thesis and therefore offer useful insights into industrial strategies for developing countries.

The literature review also discusses EPZs and their impact on economic development in terms of exports, linkages with domestic firms, and job creation. The literature in this section consists of previous research conducted on EPZs in various countries.

Finally, theories on labour and development will be examined and discussed. Specific emphasis is placed on the influence of changes in approaches to industrial development and how this has affected labour in developing countries. This section is particularly relevant to EPZs because employment creation is one of the central objectives of governments when they implement EPZ programs.

The overall objective of this literature review is to offer a useful analytical framework for interpreting the empirical data in this thesis with regards to EPZs in Kenya and their role in industrialization.

Industrialization and Development

Import Substitution Industrialization

The concept of Import Substitution Industrialization (ISI) grew out of a school of development theory that was popularized in the 1950s and 1960s by a group of scholars known as structuralists and a subsequent group of scholars that built on this work known as neo-structuralists, which included those in the dependency school. The early structuralist theorists, such as Raul Prebisch and Hans Singer believed that underdeveloped economies remained underdeveloped because the domestic manufacturing sector was very small compared to the traditional sector. The traditional sector was defined as smallholder labour-intensive farming as well as artisanal craftsmanship. The imbalance between the traditional sector and the modern industrial sector resulted in a domestic market with weak purchasing power because wages in the traditional sector were far lower than that of the manufacturing sector (Martinussen 1997: 74). Furthermore, Prebisch and Singer suggested that there was deterioration in the terms of trade between countries in Latin America, Africa, and Asia and countries in North America and Europe; this idea would become known as the ‘Prebisch-Singer Hypothesis’ (Kay 2006: 202).

The deterioration in the terms of trade was due to that fact that underdeveloped countries sell their commodities to industrialized countries and then must buy manufactured products back from the industrialized countries at a much higher price than what the raw materials making up those products are worth. Furthermore, decreases in commodity prices are not matched by a commensurate decrease in the cost of manufactured goods. Stated differently, commodity prices are far more elastic than the price of manufactured goods. Hence, the terms of trade are in a steady state of deterioration regardless of the price of commodities. Because of this steady decline in the terms of trade, it becomes more difficult to purchase inputs needed for industrialization. In addition, the wages in commodity-based industries are much lower than those in the manufacturing industry, making it difficult for the growth of a large domestic market with enough income to support a domestic manufacturing sector. Prebisch believed that there needed to be a comprehensive change in this unbalanced system of production. He stated, "It is very important to recognize the need for such structural changes in the composition of production in order to remedy the trend toward external disequilibrium that normally makes itself keenly felt in balance-of-payments crises" (Prebisch 1981: 567). Hans Singer also arrived at the same conclusion in his study of development, even though he was working independently from Prebisch. In his book *International Development: Growth and Change* Singer states that,

All the evidence is that productivity has increased if anything less fast in the production of food and raw materials, even in the industrialized countries but most certainly in the underdeveloped countries, than has productivity in the manufacturing industries of the industrialized countries (1964: 165-166).

The structuralists believed that the necessary solution to the problem of uneven terms of trade was for the government to help stimulate domestic manufacturing. One of the key policies put forward by Prebisch and Singer to help stimulate domestic manufacturing was ISI.

ISI was a policy that was put forward by the UN Economic Commission for Latin America (ECLA) of which Prebisch was the Executive Secretary from 1950-1962 (Kay 2006: 200). Werner Baer lays out the principal policy instruments for ISI:

Protective tariffs and/or exchange controls; special preferences for domestic and foreign firms importing capital goods for new industries; preferential import exchange rates for industrial raw materials, fuels and intermediate goods; cheap loans by government development banks for favored industries; the construction by governments of infrastructure especially designed to complement industries; and the direct participation of government in certain industries, especially the heavier industries, such as steel, where neither domestic nor foreign private capital was willing or able to invest (1972: 98).

Industrialization under this model has three main components to be undertaken in successive stages. The first stage of ISI is the development of domestic manufacturing in light goods such as building materials. The second stage of ISI is the manufacturing of more complex products such as consumer goods. The third and final stage in this model is the creation of a manufacturing industry in heavy goods such as steel, automobiles, and other complex highly engineered products.

There were several factors that led to the popularization of ISI in much of the developing world in the 1960s and 1970s. In Latin America ISI was popularized partly as a result of the many prominent Latin American structuralist and *dependentista* scholars

that held influential posts in various governments, as well as bodies such as the ECLA. The popularization of ISI in Latin America in the 1960s also coincided with the liberation of many African countries from their colonizers. This provided fertile ground for structuralist and dependency theories to take root in the form of ISI throughout much of Sub-Saharan Africa as the newly independent countries sought to reduce their reliance on their former colonial masters both politically and economically. However, not all countries employing the ISI model achieved the same degree of success in industrialization; as a result, there is much debate about the effectiveness of ISI as a development strategy.

Many developing countries, particularly in Latin America as well as a few in Africa, including Kenya, experienced high GDP growth and a significant increase in manufacturing output in the 1960s and 1970s while using a variety of state interventionist policies in the market to spur industrialization. Such policies included cheap state-funded credit for domestic manufacturers, raising tariffs to prevent cheap imports from competing with domestic manufacturers, and investing heavily in large state-owned infrastructural projects such as roads, power generation, educational facilities, seaports, and airports. Despite the growth in GDP and in domestic manufacturing, there has been debate about the effectiveness and sustainability of the ISI strategy.

Currently, the dominant historical narrative of ISI is that it was a failure because it compounded the balance-of-payment crises of the 1970s due to the need to import expensive machinery used in the state-supported heavy manufacturing industries. Furthermore, critics argue that developing countries should not pursue state-led

industrialization such as ISI because it distorts markets and creates an inefficient manufacturing sector that is unable to compete on world markets. Jagdish Bhagwati, a renowned neo-classical economist, heavily criticizes ISI in his book *Anatomy and Consequences of Exchange Control Regimes*. Bhagwati suggest that an export-promoting strategy is a superior approach to development than ISI. He writes that,

One cannot suppress the thought that the success stories of South Korea, Taiwan, Brazil, Singapore, and Hong Kong would not have been quite so impressive if they had not been built partly on the failures of the countries sticking overly long to the IS[Import Substitution] strategy and their consequent export (and associated economic) lag (216).

Other neo-classical economists have adopted a similar view of ISI and often use the same countries as Bhagwati (South Korea, Taiwan, Brazil, Singapore, Hong Kong) as examples of the superiority of Export Oriented Industrialization (EOI) over ISI. Furthermore, neo-classical economists believe that the state should take a less interventionist role in the economy and instead act to ease the flow of goods, services, and capital across borders, as well as focusing on controlling inflation and investing in infrastructure that supports the growth of private capital. A more in depth analysis of EOI and neo-classical economics will be discussed in the next section of this literature review.

Despite the criticisms of ISI, other development theorists suggest that the reason the Newly Industrialized Countries (NICs), such as the ones mentioned above, successfully industrialized was not because they abandoned ISI but because they implemented state-led industrialization in the first place.

Ha-Joon Chang argues that no country has successfully industrialized without using some type of state-led interventionist policy and attributes the industrial success of the Asian NICs to ISI and other state interventions (Chang 2006: 2). Chang bases much of his argument on the development experience of South Korea from the end of the Korean War to the present whereby Korea went from being one of the poorest countries in the world to being on par with Portugal; life expectancy increased by over 20 years during this period, and infant mortality dropped from 78 out of 1000 births to only 5 out of 1000 (Chang 2007: 12). Chang states that during this era, particularly between the 1960s and the 1980s, South Korea nurtured certain industries through tariff protection, subsidies, bank ownership to provide cheap credit, and other government supports until they were mature enough to compete with international competition (Ibid: 14). In addition Chang states that,

Some big projects were undertaken directly by state-owned enterprises – the steel maker, POSCO, being the best example – although the country had a pragmatic, rather than ideological, attitude to the issue of state ownership. If private enterprises worked well, that was fine; if they did not invest in important areas, the government had no qualms about setting up state-owned enterprises (SOEs); and if some enterprises were mismanaged, the government often took them over, restructured them, and usually (but not always) sold them off again (ibid.).

To be sure, there needs to be a greater recognition of the role that state-led industrialization policies played in South Korea and other NICs.

However, the success of the state-led industrialization policies in the NICs does not fully discount the critiques of ISI that were mentioned earlier. For example, the balance of payments crisis in the 1970s, faced by many developing countries including

Kenya, was partly due to the fact that countries were importing expensive machinery for heavy industries. Nonetheless, there were also other major factors contributing to the balance of payments problem such as the oil crisis, a worldwide economic slowdown, and a deterioration in commodity prices which many developing countries depended on to maintain their foreign currency reserves. The dominant historical narrative of ISI often overlooks the importance of these latter factors in order to delegitimize the state-led model of industrialization and strengthen the argument for neo-liberal industrialization policies. The marked turn from ISI towards EOI in the late 1970s and early 1980s is deeply intertwined with a paradigmatic shift in development thinking from state-led development towards market-led development.

Export Oriented Industrialization (EOI)

The practice of manufacturing goods for export has been around as long as humans have produced and traded goods. The emphasis in this section is not to analyze the historical role of manufacturing for export in its entirety, but rather to examine the change in development thinking in the 1970s from the emphasis on state-led industrialization to market-led industrialization, as well as a policy shift from import substitution to export promotion. This shift in development policy is significant because it embodies a change not only in industrialization thinking but also in the overall ideological approach to economic development.

Underpinning the change in industrialization policy was a greater commitment to neo-classical economic theory by scholars, Western governments, and international

financial institutions such as the World Bank and the International Monetary Fund (IMF). The neo-classical critique of industrialization policies in developing countries was that government interventions had hindered the operation of markets and led to an economically inefficient form of industrialization (Weiss 1988: 171). Furthermore, the critique suggested that industrialization policies had reduced export growth and ignored specialization on the basis of comparative advantage because developing countries were trying to produce goods that could be produced more efficiently elsewhere (ibid.).

As mentioned earlier, Jagdish Bhagwati, a neo-classical economist, wrote extensively on the need for developing countries to abandon ISI and adopt EOI policies. Other scholars and economists were also influential in changing the development paradigm by extolling the virtues of EOI and criticizing the ISI model and the 'export pessimists' as Bhagwati and others categorize the earlier structuralist theorists (Bhagwati 1988: 27). Some of the most well known supporters of EOI are economists and scholars such as Bela Balassa, Juergen Donges, Anne Krueger, and Ian Little, among others. Each of these authors uses slightly different data and case studies to support his or her argument, but they generally agree that economic growth is highest in countries that pursue EOI and lower in countries that attempt to protect their domestic manufacturers through the use of tariffs, subsidies, and other import discriminating policy tools.

This group of scholars also exerted tremendous influence in powerful development institutions. For example, Jagdish Bhagwati consulted for various international organizations such as the United Nations and the World Trade Organization, Bela Balassa was a consultant with the World Bank, and Anne Krueger became the chief

economist for the World Bank from 1982 to 1986 (World Bank 2011a); Ian Little published his findings for the Development Centre of the Organisation for Economic Co-operation and Development (Little, Scitovsky, & Scott 1970). The influence of these scholars, and others sharing the same views, on governments and influential international organizations had a marked impact on the industrialization policies of LDCs. The ‘free market’ operating without government interference was becoming the new saviour that would transform developing countries into modern industrial societies.

However, it is too simplistic to suggest that everyone that supported EOI was also committed to neo-classical economics or that they all believed that the government should never intervene in the market. Among those who supported EOI there was still debate about the role that the state should play and there were cases made for varying degrees of state intervention. These debates will be explored more fully in the following section.

Ian Little was one of the earliest and most influential scholars to promote an EOI strategy for developing countries. One of his most influential works was a book, *Industry and Trade in Some Developing Countries*, co-authored with Tibor Scitovsky and Maurice Scott, which analyzed industrialization policies in Argentina, Brazil, Mexico, India, Pakistan, Taiwan, and the Philippines (Little, Scitovsky, & Scott 1970). Generally, Little, Scitovsky, and Scott conclude that countries that pursued open trade and reduced tariffs and protection for domestic industries experienced the highest economic growth. Little, Scitovsky, and Scott suggest that there is a virtuous cycle between free trade and growth: “Growth encourages measures to free trade which, in turn, encourage growth” (Ibid:

390). The idea of a virtuous cycle of free trade and growth would eventually become a mantra repeated in the 1980s by the World Bank and Western governments in their adoption of neo-liberal policies and structural adjustment policies imposed on developing countries.¹

Bela Balassa undertook a similar study on EOI and makes an argument very similar to Little, Scitovsky, and Scott. In support of EOI, Balassa states that,

[Export-oriented policies] lead to resource allocation according to comparative advantage, allow for greater capacity utilization, permit the exploitation of economies of scale, generate technological improvements in response to competition abroad and, in labor-surplus countries, contribute to increased employment (1978: 181).

Balassa supports this claim in the same paper by examining growth rates in South Korea, Singapore, and Taiwan (countries with export-oriented policies according to Balassa) and compares them with the growth rates in Argentina, Brazil, Colombia, and Mexico (countries that used import substitution to a greater degree and adopted export-oriented policies later than the first group of countries) (ibid.: 183). Balassa uses data to make the connection between increased export growth and an increase in gross national product (GNP). In general Balassa's data show that countries with the highest increases in exports, South Korea, Singapore, and Taiwan, also experienced the greatest growth in

¹ Structural adjustment policies were policies put in place by the World Bank, IMF, and developed countries that gave loans and funding to developing countries on the condition that they reduced import tariffs, cut subsidies for domestic manufacturers, privatized state-owned industries, and privatized public services. For a more thorough analysis of structural adjustment policies in Africa see *African Voices on Structural Adjustment* (2003).

GNP. The data lead Balassa to the conclusion that EOI policies are more beneficial for economic growth in developing countries than import substitution policies (ibid: 188).

In a similar study, Juergen B. Donges reviews industrialization policies in fifteen semi-industrial countries from the 1950s to the mid-1970s (Donges 1976). Donges reaches essentially the same conclusion as Balassa by suggesting that the countries pursuing EOI had the fastest rates of growth and uses Hong Kong and Singapore as the standard of reference (ibid.: 655). His recommendation is that other developing countries pursue similar policies of export promotion and reduce their protection for domestic manufacturers by lowering import tariffs.

However, Donges does not completely dismiss the usefulness of import-substitution policies; he suggests that manufacturing for a domestic market should be pursued only in sectors that are efficient and offer a long-term competitive advantage over imports. Donges suggests that instead of protecting domestic industries through tariffs, LDCs would be better served by direct subsidies through the 'infant industry' stage until they become more competitive. The direct subsidy would be more beneficial than an import tariff because it would improve production for both the domestic and export markets. Donges believes that tariffs, used in past ISI policies, were an inferior policy because they overvalued domestic currencies because of restrictions on imports; the overvaluation made exports more expensive and therefore less competitive. Furthermore, Donges contends that resources were being wasted on producing 'inessential' goods that were restricted from importation at the expense of producing essential goods; this made the use of resources more inefficient (Ibid.: 636-37). Overall

Donges believes that protectionist import-substituting policies favoured industries that were less efficient and/or less essential and this was a drag on the economy because it retarded productivity (Ibid.: 636).

Anne Krueger joins Balassa and Donges in her support for export promotion in developing countries. Her argument follows the same rationale as the other authors by stating that developing countries that experienced the highest growth in GNP also pursued export-promotion policies (Krueger 1980: 289). Krueger analyzes three hypotheses that attempt to explain why export-promotion is a superior policy to import-substitution in achieving higher rates of economic growth. The first hypothesis is that export promotion allows the construction of manufacturing plants that are of a minimum efficient size because they can produce for a larger market and this allows for increasing returns to scale; the plants are also run more efficiently because they are required to compete in the international market (Ibid.: 289).

The second hypothesis is that import substitution policies were flawed in their implementation; this hypothesis does not fully discount import substitution in its entirety, but rather the aspects that were hindering productivity and leading to market distortions. An example given to support the lack of productivity was that import substitution policies rewarded entrepreneurs for license-getting abilities as opposed to productivity improvements (Ibid.: 291). The hypothesis also suggests that import substitution became more focused on foreign exchange saving instead of developing new industries (Ibid.: 291).

The third hypothesis that Krueger examines suggests that economic growth would be optimal in the absence of intervention regardless of whether this intervention was intended to support import substitution or export promotion (Ibid.: 291). This hypothesis argues that export promotion is superior to import substitution but any intervention supporting export promotion, whether it is a tariff, subsidy, exchange control, licensing, or other intervention in support of export promotion, would essentially distort the market. She states, “The commitment to an export-oriented development strategy implies a fairly liberal and efficient trade regime, and thus prevents paperwork, delays, bureaucratic regulation, and other costs that can arise under import substitution. This in turn limits the restrictions that can be imposed on capital account” (Ibid: 291). This hypothesis presented by Krueger forms the backbone of the argument used to implement neo-classical economic reforms both in the developing and developed world. However, an important aspect of this hypothesis that needs to be emphasized is that this ‘hands-off’ approach to economic development and export promotion works best if all countries adopt the same approach and reduce barriers to trade; this is one of the key tenets of free-market capitalism. Krueger also makes note of this stating, “It is, of course, to be hoped that protectionist pressures in the developed countries do not result in fewer opportunities for the LDCs [less developed countries]. If such protectionist measures are taken, they will lower the rate of return to outward-oriented trade strategies” (Ibid: 292).

Krueger suggests that all three hypotheses have some element of truth, but that none of the hypotheses on their own can fully account for differences in economic

performance between import substitution and export promotion (Ibid.: 292). However, Krueger maintains that EOI is superior to ISI in pursuing economic growth.

The most popular arguments for the implementation of EOI have supported pro-market and non-state interventionist policies. However, there has been considerable debate about the degree and manner in which governments should be involved in export promotion. There are also critiques that question whether all forms of protection for domestic manufacturers should be eliminated as many neo-classical theorists suggest.

Within EOI theory there is a diversity of views with regard to the level of state intervention for the support of export manufacturing. On one side of the spectrum is the neo-classical school of thought that believes the role of the state in relation to industrial policy should be limited to maintaining macro-economic stability by way of setting interest rates to control inflation and making the tax system stable and simple, providing a free and flexible capital market without sectoral protection, limiting the power of monopolies, building and maintaining infrastructure such as roads and ports to facilitate more efficient trade, providing education to provide a more productive workforce, and maintaining political and economic stability to attract foreign direct investment (Corden 1980: 182-83). However, according to the neo-classical approach, direct interventions in the market by the state through subsidy or tariff protection are to be avoided. This approach to industrialization became the dominant view of the large international financial institutions, as detailed in the previous section. The supporters of the neo-classical approach to export promotion include those mentioned earlier such as Balassa, Bhagwati, Donges, Krueger, Little, Scitovsky, and Scott.

On the other side of the spectrum there are export-promoters that believe the state has an important role to play by directly intervening in the market through a variety of methods including but not limited to export subsidies, cheap credit, and in some cases nationalization of certain firms or industries. This approach was supported by many of the early structuralists and dependency theorists that are generally associated with ISI and inward-oriented industrialization. These ‘export pessimists’, as Baghwati labels them, were not necessarily anti-export but were more concerned about what was being exported in relation to what they were importing. They also believed that it was necessary for the state to intervene in the market in order to encourage the development of higher value manufacturing, regardless of whether the products were for the domestic market or for export. This is a key distinction that is often missed when ISI is compared to EOI.

With regard to state protections for domestic industries, neo-classical economists are criticized for wrongly associating state protection (tariff and non-tariff trade barriers) of domestic industries with hindering economic growth. For example, Francisco Rodriguez and Dani Rodrik, in a study on trade policy and economic growth, state that, “if there is an inverse relationship between trade barriers and economic growth, it is not one that immediately stands out in the data” (Rodriguez and Rodrik 2001: 262). Their claim is based on an analysis of a number of countries from 1975-1994 that compares tariff and non-tariff trade barriers and economic growth in terms of per-capita GDP between these countries. The study shows no statistical significance between trade barriers and economic growth:

The figures show the relationship between these measures and growth after controlling for levels of initial income and secondary education. In both cases, the slope of the relationship is only slightly negative and nowhere near statistical significance. This finding is not atypical. Simple measures of trade barriers tend not to enter significantly in well-specified growth regressions, regardless of time periods, subsamples, or the conditioning variables employed (Ibid.).

Rodriguez and Rodrik do not dispute that some trade liberalization may be beneficial but they conclude their study by saying that, “What we dispute is the view, increasingly common, that integration into the world economy is such a potent force for economic growth that it can effectively substitute for a development strategy” (Ibid.:318). The NICs are often used by neo-classical economists as an example of the success of trade liberalization to promote industrialization and achieve economic development objectives. However, a closer examination of this model suggests that the governments of the NICs used a mixture of market-led and state-led policies to achieve successful industrialization objectives.

The Developmental State

The developmental state model as practiced in NICs such as South Korea, Taiwan, and Hong Kong employed both ISI policies and EOI policies using a combination of state support, and in some cases state protection, as well as private FDI. Understanding this model of industrialization is necessary because it provides important insights into the way in which effective industrial strategies can help achieve economic development objectives in developing countries. The significant growth of the East Asian

economies has generated plenty of debate among those that have sought to explain the reasons for this growth. John Martinussen provides a useful typology of approaches that are used to interpret the conditions for growth in the NICs; according to Martinussen, the approaches consist of the pure neo-classical economics view, the revisionist view, and the functional approach (1997: 269). The neo-classical view is employed by economists such as Jagdish Bhagwati, Edward Chen, and Charles Wolf; the revisionist view is used by scholars such as Alice Amsden, Ha-Joon Chang, and Robert Wade; and the functional approach is used by the World Bank (Ibid.). An evaluation of these three approaches will be undertaken to determine which one is the most useful in explaining the industrialization success of the NICs. Furthermore, understanding the approach that best interprets the industrialization process in the NICs will offer some useful implications for industrialization in Kenya.

The pure neo-classical view became popular in the late 1970s and early 1980s. This view attributed most of the success of the NICs to non-intervention by the state in price formation, foreign trade, and the economic functioning of private enterprises (Ibid.). Additionally, the supporters of this view suggest that much of the success of the NICs is due to a stable macro-economic framework, openness to free trade, and government investment in health and education. For example, Edward Chen, in his study of economic growth in Hong Kong, Japan, Korea, Singapore, and Taiwan suggests that the industrial success of these countries is due to a number of factors that are adhere to neo-classical economic theory. First of all, Chen states that these economies allocate resources efficiently because they are free of government interference:

What the State has provided is simply a suitable environment for the entrepreneurs to perform their functions. In Hong Kong, Japan, and Singapore, institutional and historical factors have resulted in a free-enterprise environment in which entrepreneurs can work with maximum flexibility. In Korea and Taiwan, the 'correct' environment for entrepreneurs has developed as a result of various changes in the monetary system, the correction of the over-valued foreign exchange rate, and the relaxation of restrictions on foreign trade. These measures had the effect of removing impediments to the working of the price mechanism (1979: 183-84).

The argument made by Chen is that the government provided a stable macro-economic framework free of price distorting interventions that allowed private capital to flourish. Additionally, Chen states that high savings rates were achieved in these economies "without direct government intervention" (Ibid.). He suggests that the high savings rates "were due to the thriftiness of the people and partly due to the abundant supply of entrepreneurs who are normally the important savers" (Ibid.). Finally, Chen argues that the countries under study achieved export-led growth by removing impediments to the functioning of free markets, allowing investment into labour-intensive manufacturing in which the countries had a comparative advantage (Ibid.: 185).

Chen's interpretation of the NIC's development success was echoed by other economists such as Jagdish Bhagwati (1988) and Charles Wolf (1988) and generally became accepted as the 'correct' approach in interpreting the economic success of the East Asian economies. However, revisionists, such as Alice Amsden, Ha-Joon Chang, and Robert Went, began challenging the neo-classical economics interpretation in the late 1980s, and took issue with many of the main arguments used to support the neo-classical approach.

Robert Wade used the example of Taiwan to suggest that the country had a long history of state-led industrialization dating back to the 1950s that was largely responsible for the growth in the industrial sector (1990). Wade argues that the neo-classical interpretation gives insufficient weight to the role of the state, especially during the transition from inward oriented industrialization to export oriented industrialization (Ibid: 109). Wade suggests that the state directed resources into industries important for future growth by using import substitutes in export production for products like synthetic fibres, plastics, and electronics (Ibid.: 110). He adds that, “Multinational companies became important players in these [industrial] developments, but only *after* the state had a well-established presence and leadership position from which it could channel their activities rather than be made subordinate to a logic of global profits (Ibid.). This interpretation of industrial development is contrary to Chen’s argument that the state merely provided an enabling environment for entrepreneurs to invest in new industries without direct state support.

Alice Amsden comes to the same conclusion as Wade in her analysis of industrial policies in several developing countries including NICs.² Amsden suggests that it was the ability of import substitution policies to transform manufactures for the domestic market into manufactures for the export market. She states that,

Whatever the country, capital formation and exporting were intermediated by import substitution. Virtually every manufactured export, save the most

² According to Amsden the Newly Industrializing Countries or ‘the rest’ as she labels them are comprised of, “China, India, Indonesia, South Korea, Malaysia, Taiwan, and Thailand in Asia; Argentina, Brazil, Chile, and Mexico in Latin America; and Turkey in the Middle East” (Amsden 2001: 1).

labor-intensive (apparel and software), emerged out of an import substitution industry. The superprofits earned through selling in the protected domestic market helped to finance the learning and scaled economies necessary to export (Amsden 2001: 188).

In her analysis of the late industrializing countries, Amsden finds that there was a variety of interventionist policies used to promote exports. These policies include direct subsidies of exports such as tax breaks and duty drawbacks on imports, long-term state subsidized loans, tariff protection, and local content requirement for foreign firms setting up manufacturing plants, particularly in the auto sector (Ibid.: 148-154; see also Chang 2006, 2007).

The revisionist interpretation of the industrial success of the emerging East Asian economies represented a significant departure from the previous neo-classical economics interpretation. This revisionist interpretation forced mainstream development institutions such as the World Bank to re-evaluate their own interpretation of the policies that contributed the industrial ascendancy of these countries. Interestingly, this came at a time when the World Bank, IMF, and Western countries were forcing developing countries to adopt neo-classical economic policies through structural adjustment programs and conditional lending. A full admission by the World Bank that state-led intervention was an important factor in the successful industrialization process in East Asia would appear hypocritical as it was forcing developing countries to liberalize their economies and adopt neo-classical economic reform.

The World Bank response to the revisionist interpretation was the publication of a comparative study of economic growth and public policy in East Asia called *The East*

Asian Miracle: Economic Growth and Public Policy (1993). The report admits that “some selective interventions contributed to growth” (Ibid.: vi). However, the report states that the interventions only succeeded under three conditions: first of all “they addressed problems in the functioning of the markets”; secondly, “they took place within the context of good, fundamental policies”; thirdly, “their success depended on the ability of governments to establish and monitor appropriate economic-performance criteria related to the interventions – in the authors’ terms, to create economic contests” (Ibid.). The World Bank suggests that the interventions are the exception rather than the rule: “The authors [of the report] conclude that rapid growth in each economy was primarily due to the application of a set of common, market-friendly economic policies, leading to both higher accumulation and better allocation of resources” (Ibid.). Although, the World Bank continued to emphasize market-led industrial policy as the key factor in the success of the NICs, the admission that state intervention, albeit limited, played a role in industrialization signaled a significant departure from the World Bank’s previous position that state intervention had no role in the industrial success of the East Asian economies. The World Bank also downplayed any possibility that state interventions, particularly protection of domestic industries, could be implemented effectively in other developing countries: “We conclude that promotion of specific industries generally did not work and therefore holds little promise for other developing economies” (Ibid.: 354). The one state intervention the World Bank recommended for other developing countries was export promotion or what it terms as an ‘export-push strategy’. After categorically rejecting the usefulness of state intervention in protecting domestic industries, the World Bank,

suggests that export promotion measures such as “export credit, providing tax incentives, or improving access for small and medium exporters” (Ibid.: 361) could be useful for developing countries trying to establish an export oriented industrial sector. The World Bank’s recommendation of state involvement in export promotion is of particular relevance to the establishment of EPZs because many of the same export promotion policies, particularly tax incentives, are used to attract export oriented manufacturing firms.

The various interpretations of the industrialization process in the NICs has significant implications for industrial policies of other developing countries. The shaping of this debate by neo-classical economists, the revisionists, and the World Bank has directly influenced the policies adopted by countries such as Kenya. The view that state-intervention, especially in the domestic industry, should be avoided in favour of market-led industrial development has generally prevailed. The government of Kenya has adopted this view, although not always willingly, since the 1990s and continuing into the current era (this will be explored more fully in Chapter 2). Beeson & Islam (2005) suggest that there are often tensions in policy making between appeasing investor confidence and serving national interests. They state that,

When they [nations] gear their entire national development strategy to the preferences of and sentiments of global markets – often subsumed under the rubric of attracting and sustaining investor confidence – they may be forced to shun the voices and concerns of domestic constituencies and the strategic directions that a nation ought to take. This inadvertently undermines democratic governance and may well cause the tensions between domestic stakeholders and foreign constituencies to become unmanageable. Under such circumstances, crafting a credible national

development strategy becomes rather difficult (Beeson & Islam 2005: 211).

Beeson & Islam are commenting specifically on the East Asian development experience but the same critique is true for Kenya. The process of economic liberalization that began in earnest in the 1990s has done little to improve the performance of Kenya's manufacturing sector to date. The adoption of the neoliberal approach in industrialization is explicitly linked to the development of EPZs in Kenya. However, it is important to note that the prevalence of the World Bank's industrial policy prescriptions in Kenya is not without its critics and its interpretation of the industrialization process in East Asia remains contested by many.

Export Processing Zones and Industrialization

The creation of EPZs is taking place in a number of developing countries in an effort to quicken the pace of industrialization. Although there are several different types of EPZs, they generally share some of the same basic characteristics; Peter Warr provides a useful definition describing some of these characteristics. Generally EPZs are built as,

Special enclaves, outside a nation's normal customs barriers, within which investing firms, mostly foreign, enjoy favoured treatment with respect to imports of intermediate goods, company taxation, provision of infrastructure and freedom from industrial regulations applying elsewhere in the country...A universal feature is the almost complete absence of either taxation or regulation of imports of intermediate goods into the zones. These privileges are subject to the conditions that almost all of the output produced is exported and that all imported intermediate goods are utilized fully within the zones or re-exported (Warr 1990: 130).

Ireland was the first country to create an EPZ, called the Shannon Free Zone, in 1958; many developing countries, including Kenya, have adopted a similar model of EPZ based on the Shannon Free Zone.

In the 1950s, Shannon was in a state of economic decline so the government embarked on a program to create employment in the area by turning the airport and the area around it into an Industrial Free Zone as a site to attract international investment into manufacturing for export. The main incentives used to attract investment were duty free imports of raw materials and capital equipment and tax exemptions on profits earned through export activities (APHD 1986: 34). The Shannon Free Zone was part of a broader government strategy to pursue EOI. In the 1960s Ireland signed a free trade agreement with Great Britain, which was extended to the European Economic Community (EEC) in 1973 when Ireland became a member (Ibid.: 31). Ireland became an attractive country for companies to set up manufacturing facilities because of its labour cost advantage compared with other Western European countries and its proximity to large markets such as Great Britain, France, and Germany (Ibid.: 32).

However, when lower-wage countries such as Greece, Spain, and Portugal joined the EEC, Ireland's cost advantage eroded and it became less advantageous for foreign companies to manufacture in Ireland (Ibid.: 32). Furthermore, the Telesis Report of 1982, a report on the contribution of foreign firms to industrialization in Ireland, stated that foreign firms operating in Ireland used few Irish inputs (backward linkages) and did not contribute to long-term sustained increases in employment (Ibid.: 33).

The idea of creating EPZs is strongly linked with the export promotion theories that were discussed earlier in this section, particularly those that adhere to neo-classical economics. At first glance it appears that EPZs subscribe to neo-classical economics because they are free from import tariffs and other barriers and regulations that would interfere with the free movement of imports and exports. However, EPZs diverge from some of the principles of neo-classical economics because exports are given favourable treatment, by the state, over production for the domestic market. Some of the incentives that diverge from neo-classical economics include subsidized electricity rates for manufacturers, subsidized infrastructure, services sold below the market rate to manufacturers, and tax exemptions for firms in EPZs not given to domestic manufacturers. A true neo-classical economic approach would favour neither manufacturing for the domestic market nor manufacturing for export through state intervention, because this would distort 'natural' comparative advantages and lead to market inefficiencies.

Regardless of the inconsistencies between EPZs and neo-classical economic theory, EPZs are embraced by development theorists, international financial institutions (namely the World Bank and the IMF), and developing country governments as a formula for industrialization. However, EPZs have also come under criticism from organized labour, development scholars, economists from diverse ideological backgrounds, non-governmental organizations, and other civil society groups both in developed and developing countries.

The purpose of this section is to analyze the literature from various viewpoints with regards to EPZs. I will first analyze the literature on EPZs by neo-classical theorists that generally support export promotion but have varying views on the usefulness of EPZs.³ Secondly, I will evaluate the literature written by those that favour protection of domestic manufacturing and believe that the state should take a more interventionist role to promote manufacturing; more generally this literature adheres or partially adheres to ISI strategy.

The objective of this discussion is not to analyze all of the literature with regards to EPZs; an undertaking of such magnitude lies beyond the scope of this thesis. However, for the purpose of my research I will focus specifically on the EPZ debate with regard to its impact on industrialization and potential for economic development in developing countries.

Export Promotion and Export Promotion Zones

EPZs, also known as Free Trade Zones or duty free zones, became popular in the 1960s and 1970s in Asia, and subsequently in Latin America, the Caribbean, and Africa. India was the first Asian country to set up an EPZ in 1965, Taiwan established its first EPZ in 1966, and South Korea constructed its first in 1970 (Amirahmadi & Wu 1995: 831). EPZs became more accepted as a tool for industrialization as the paradigm in development theory shifted from state-led development to market-led development.

³ This typology of EPZ literature is adapted from Madani (1999: 83).

Many theorists suggested that one of the central reasons NICs in Asia industrialized quickly was because they created EPZs as part of their export promotion policies. The main arguments used to support EPZs are that they generate foreign exchange needed to finance imports of industrial inputs and capital goods, they help to achieve economies of scale, they provide employment, and they contribute to growth in GNP (Johansson and Nilsson 1997: 2115). However, export promotion supporters debate the benefits that EPZs provide to a developing country.

Initially neo-classical economists suggested that EPZs had negative effects on developing countries, particularly countries with import tariffs, because it created two different markets: one market for exporting goods and one market for domestic goods. This was a problem because EPZs drew labour from the domestic market, which was primarily labour intensive, and this made the production of labour-intensive goods less advantageous because labour became more scarce (Hamada 1974; Madani 1999: 83). However, one flaw in this criticism is that it is based on a labour market at full or near full employment and many developing countries have a large pool of surplus labour. This means that EPZs do not significantly distort domestic labour markets because they would be drawing labour from a large pool of unemployed individuals.

Subsequent neo-classical economists suggested that when other factors are taken into consideration, EPZs provide positive benefits for developing countries. One of these factors was the perceived trend that countries that create EPZs are more prone to open up other parts of their economy by reducing import tariffs so that they become more competitive (Devereux and Chen 1995: 712). Therefore, according to this theory, the

EPZ is not necessarily beneficial in itself, but acts as a catalyst to move the country forward in adopting neo-classical economic reforms such as reduced tariffs, less government intervention in industry, and fewer restrictions on FDI.

Another method of evaluating the impact of EPZs on developing countries is to use a cost-benefit analysis. This method, employed by a number of researchers, encompasses a variety of factors to determine if EPZs provide a net benefit to the welfare of a developing country. Peter Warr uses this method in his research on EPZs in Indonesia, South Korea, Malaysia, and the Philippines. He examines the implications on a country's economic welfare based on the profits and losses of a firm in an EPZ, foreign-exchange earnings by EPZ firms, employment, technology transfer between EPZ firms and domestic firms, domestic sales of EPZ products, purchase of domestic raw materials and capital goods (backward linkages), electricity use, domestic borrowing, taxes, and development and associated costs of developing and maintaining an EPZ (Warr 1990: 146-51). According to Warr, the most commonly used arguments for governments supporting EPZ development is that they provide "foreign exchange earnings, employment and technology transfer" (Ibid.: 157). With regards to foreign exchange earnings and employment, he finds that the EPZs contribute significantly; however, he argues that an insignificant amount of technology transfer has taken place between EPZ firms and domestic firms partly because EPZ firms use very few domestic inputs for manufacturing (Ibid.: 158). Furthermore, Warr finds that EPZ firms contribute very little to tax revenues due to generous tax holidays. Warr also found that in the Philippines the infrastructural costs of building and maintaining the EPZ outweighed the

sum of all benefits, and the cost of subsidizing electricity in the Malaysian EPZ outweighed the combined benefits from the use of local raw materials, local capital equipment and all tax revenues raised from EPZ firms (Ibid.: 157). Warr's conclusion is that EPZs have a very limited impact as catalysts for development using the cost-benefit analysis; he suggests that developing countries would be better off liberalizing their domestic economy in accordance with neo-classical economic principles instead of developing EPZs (Ibid.: 160). Thus, Warr offers the same prescription for economic development as Devereux and Chen, but he provides a useful methodology for evaluating EPZs by looking at the costs and benefits of a wide variety of factors relating to EPZs.

New Growth Theory, a term used by Dorsati Madani, attempts to go beyond the cost-benefit analysis of measurable factors such as employment creation, tax revenue, and infrastructural costs discussed above (Madani 1999: 84). New Growth Theory attempts to capture more abstract externalities of EPZs, such as their impact on domestic manufacturer exports and their potential to act as a catalyst to make domestic firms more productive and competitive by demonstrating better production methods and training of local workers and managers. Helena Johansson and Lars Nilsson use this theory to suggest that EPZs have a catalytic effect on domestic manufacturers (Johansson and Nilsson 1997: 2115). To quantify this effect, they determine whether the establishment of EPZs affects total host country exports (Ibid.: 2116). Their data show that there is indeed a correlation between increases in EPZ exports and increases in host country exports outside of the EPZ in the case of the Malaysian EPZs. As exports in EPZs increased, so did exports in non-EPZ production (Ibid.). Johansson and Nilsson suggest that the reason

for this correlation is that, “EPZs may contribute to economic development by the bringing of export know-how to the host country, thereby reducing the idea gap present in many developing countries” (Ibid.: 2123).

Although Johansson and Nilsson show a correlation between EPZ exports and host country exports, it is hard to establish with certainty that host country exports are increasing because of EPZs and not because of other factors. There may indeed be some catalyst effect on host country exports due to the establishment of EPZs, but it cannot be concluded with any certainty that EPZs are the most important factor in increasing host country exports, rather than other factors, such as international demand for products, exchange rates, firm competitiveness, political stability, or macroeconomic policies.

In the case of many African countries, governments have established EPZs in the hope that they would transform the industrial sector into a leading driver of the economy by producing a greater variety and volume of manufactures higher in the value chain. However, the establishment of EPZs in several SSA countries such as Namibia, Lesotho, Malawi, and Swaziland has failed to substantially alter the industrial sector (Jauch 2002; Kaplinsky 2007). Some EPZs in SSA experienced manufacturing growth in the apparel sector in the 1990s and early 2000s, but when the Multi-Fibre Agreement expired in 2005, many manufacturing firms re-located to lower cost jurisdictions in Asia. This trend reinforces the hypothesis put forward by Rolfe, Woodward and Kagira (2004) that investments in African EPZs, particularly in textiles and apparel, are footloose and only seek to take advantage of short-term tax incentives and will easily re-locate to other jurisdictions when there are opportunities for better tax incentives. Rolfe, Woodward, and

Kagira state that, “Basing a development strategy on garment exports is questionable at best. Apparel is the quintessential footloose industry, opting for short-term tax incentives” (Ibid.). The footloose nature of investments in EPZs and the predominance of low skill textile and apparel manufacturing also influence the quality of employment in EPZs. The relationship between labour theory and EPZ development will be explored more fully in the following section.

Labour and Development

This section of the literature review will examine some of the most influential labour theories, in relation to industrialization, and their impact on development. The purpose of delving into labour theory literature is to place employment in EPZ development within a broader theoretical context. This section parallels the previous section by analyzing labour theories associated with production for a domestic market and then analyzing labour theories associated with producing for export markets. The first part of this section will review literature on Fordism and its impact on employment and development. The second part of this section examines the changing nature of employment and industrialization in the 1960s and 1970s as countries switched from ISI to EOI. Lastly, various interpretations of the impact of EPZs on employment will be explored in relation to labour theory.

Fordism

Fordism has its roots in the production methods of Henry Ford in the 1910s, which were considered revolutionary at the time. A major component of Fordism involved the specialization of labour, whereby individual labourers at the assembly plant were responsible for one specific task as the assembly line moved. This production method incorporated much of the Taylorist principles of speeding production by keeping machinery continuously running, thereby limiting the loss of time involved in starting up

machinery and preparing production runs (Aglietta 1979: 116)⁴. This process vastly increased production and decreased the amount of training needed for workers because they only had to complete a few tasks instead of being involved in many different aspects of production.

Another significant aspect of Fordist theory involved the way in which labourers were paid. Ford introduced a daily wage rate to replace piece rates and he also paid his labourers significantly higher wages than other employers so that he could attract a healthy and productive labour force to maximize production (Munck 2002: 31-32). Ford also believed that paying workers enough to buy the products that they built would further stimulate demand for his vehicles. In defense of his high-wage model, when compared to other wages in similar industries, he states, “why do we hear so much talk about the ‘liquidation of labour’ and the benefits that will flow to the country from cutting wages – which means only the cutting of buying power and curtailing of the home market?” (Ford 1923:116). This highlights one of the key elements of Fordism; it was designed for a system of domestic consumption. Ford’s vehicles were, for the most part, produced and consumed domestically which added to the incentive to pay workers a wage so that they could afford to consume the products. This is a key aspect of Fordism because it contrasts significantly to the EPZ model of production where goods are

⁴ Taylorism became the dominant method of industrial production in the late 19th century in the United States and Western Europe. Taylorism emphasized the study of time and motion in the production processes to make them more efficient and human labour power was reduced to a cycle of repetitive movements and the qualitative characteristics of labour were transferred to machines. Human labour power thus became homogenized on a massive scale (Aglietta 1979: 113-116). See Aglietta for a more detailed overview of Taylorism.

manufactured almost exclusively for foreign markets resulting in little incentive to pay wages that would stimulate domestic demand.

The Fordist mode of production, both the introduction of a daily wage rate, and the reorganization of the factory also had significant implications for the development of society. The higher wages paid under Fordism meant that workers could afford to purchase basic necessities such as food, shelter, and clothing which was very important because a healthy labour force also meant a productive labour force. Gramsci suggested that the higher wage rates were necessary because they offered "...the possibility of realizing a standard of living which is adequate to the new methods of production and work which demand a particular degree of expenditure of muscular and nervous energy" (Gramsci 1971: 312). The higher wages also meant that factory labourers could purchase a widening array of consumer goods such as automobiles and various household appliances in turn creating more demand for factory produced goods. As Fordism became more entrenched in the American system of production it created a fast growing middle class of consumers that ushered in the post-WWII 'golden age' of US capitalism. Similar transformations took place in Western European countries as they rebuilt after WWII⁵. Fordism also depended greatly on the Keynesian Welfare State (KWS) in order to remain the dominant mode of production. Rising consumption coupled with stable growth and increasing state funded social welfare services such as infrastructure, health, education, state pension plans, and state regulated employment benefits allowed Fordism to go

⁵ For a typology of the different variants of Fordism in various countries see Tickell and Peck 1995: 362. Full reference in Works Cited.

relatively unchallenged until the mid to late 1960s (Ramasamy 2005: 9-10). Ramasamy states that the Fordist structure of accumulation coupled with the Keynesian mode of regulation allowed for a social pact between labour and capital, regulated by the state, that drew wide support from the working classes and allowed it to go unchallenged by more radical labour factions (Ibid.). Antonio and Bonnano refer to this era as High Fordism because the gains in private sector productivity coupled with the state's Keynesian management of aggregate demand through monetary regulation and state spending created a balance between production and consumption, a low unemployment rate, steady accumulation, and high rates of profit (Antonio and Bonnano 2000: 36-37).

Although, Fordism was the dominant mode of production and regulation in the US and variants of it were present throughout Europe and Japan, it was never achieved to the same scale in countries of the developing world. Until the 1960s most of the countries in the Global South had been supplying raw materials to the Global North for the production of manufactured goods. This meant that there was an absence of a growing urban working class engaged in factory production similar to what was happening in the US and parts of Europe. Therefore, the Fordist mode of production and consumption could not take hold in the same manner because there was a lack of a domestic working class to consume the products. Structuralist theorists such as Raul Prebisch and Hans Singer suggested that the lack of production of manufactured goods in countries of the South was one of the reasons why these countries were underdeveloped (Prebisch 1981; Singer 1964). The structuralist theories eventually led to the adoption of Import Substitution Industrialization (ISI) in many developing countries in order to create a

working middle class and achieve the same ‘golden era’ growth as the United States and Western Europe (see section on ISI in the previous section). Kenya’s experience with ISI and its impact on labour and development will be examined more thoroughly in chapter 2.

However, by the late 1960s and early 1970s the ‘golden era’ of growth in the United States and Europe was coming to an end. Michel Aglietta (1979) suggests that there was an over-accumulation of capital because it was becoming more difficult to achieve productivity gains, and there was growing resistance to the intensification of labour. There were also new economic threats from Asian manufacturers and an oil crisis that threatened to undermine an economic system that was reliant on cheap oil for both production and consumption. Politically, the hegemony of the welfare state was being questioned because of the US failure in Vietnam, the rise of anti-Western movements, and new political alignments such as OPEC (Antonio & Bonanno 2000: 37-38). The challenges to the KWS and Fordism changed the labour process significantly in the Global North and South and new theories were developed to explain this transformation.

New International Division of Labour

The New International Division of Labour (NIDL) is an approach used to offer an explanation for changing production and labour processes in the 1960s and 1970s. Supporters of the NIDL approach such as Folker Fröbel, Jürgen Heinrichs, and Otto Kreye argue that the division of labour between the Global North and Global South began to experience a tremendous shift in the 1960s (Fröbel, Heinrichs, and Kreye 1980). They

suggest that the role of the Global South as a provider of raw materials for Northern manufacturers began to change because there was a breakdown of traditional social economic structures in the South allowing for the emergence of a large pool of cheap available labour (this is partly due to increasing migration from rural areas to urban areas as peasants could no longer survive on small subsistence farming due to the changing nature of agricultural production), a fragmentation of the industrial production process allowing for unskilled sub-processes to be relocated to the developing world, and a revolution in transportation and communications technology making relocation of industrial processes to the South easier (Ibid.).

The NIDL approach is a useful tool for analyzing the changing nature of worldwide export oriented manufacturing processes, especially in textiles and electronics, but there are significant weaknesses in the approach when it is generalized to explain the entire world labour system. For example, Ronaldo Munck criticizes the NIDL approach for dismissing industrialization processes in the developing world prior to the 1960s, as well as dismissing the role of the state as though the ‘world market’ existed beyond state control (Munck 2002: 40). Robin Cohen also criticizes NIDL for overstating its claim that there was a ‘new’ division of labour (Cohen 1991: 123-149). He argues that there have always been divisions of labour divided by gender, class, race, or geographical location; there were sharp divisions of international labour in previous eras and NIDL understates this fact. In reference to the emphasis that NIDL places on newly industrializing Asian countries (NICs) as evidence of a ‘new’ division of labour Cohen states,

How new is the 'new' international division of labour? There is no way of determining this from the theory itself, as no historical comparisons with other international divisions of labour are provided. It is as if the NIDL theorists boarded a time machine in the mid-nineteenth century to arrive at Hong Kong and Singapore late last night, without bothering to land at any of the intermediate airports – notably those marked on the historical maps as 'Imperialism' and 'Colonialism' (Ibid.: 133).

However, criticisms aside, NIDL theory remains a useful tool for explaining changing global labour patterns within specific manufacturing industries, and helps to explain the growth in Export Processing Zones (EPZs) in the developing world during the 1960s and 1970s. Munck and Cohen also believed that NIDL was a useful tool for analysis in this area despite their criticisms (Munck 2002; Cohen 1991: 149). Because of this strength NIDL is a good basis for exploring the development potential of EPZs with regard to labour.

NIDL explains how the labour characteristics of EPZs marked a clear departure from Fordist principles. In the Fordist model of production it was necessary to cover the costs of the reproduction of workers⁶ and pay them enough to stimulate domestic demand, however the NIDL theorists suggest that wages in EPZs often do not cover the costs of the reproduction of workers because there is an almost unlimited supply of cheap labour and the products being manufactured are for export leaving little incentive to create domestic demand through higher wages (Fröbel et al. 1980). However, other

⁶ In this context reproduction of workers refers to paying a wage that allows for a healthy and productive labour force because they are able to use their wages to pay for adequate food, shelter, clothing, health etc. Furthermore, it allows workers to reproduce offspring that are adequately taken care of through education, health, clothing etc. and will become productive workers themselves when they reach maturity.

aspects of Fordism such as the Taylorist structuring of factories whereby human labour power is reduced to a series of repetitive movements are still used in EPZs. From a development perspective the NIDL break from Fordist principles, in terms of the wage model and the connection to the welfare state, raises an interesting issue; if workers in export-oriented industries are not paid a wage to cover the cost of reproduction, how does this contribute to development?

The NIDL theorists argued that there was little if any development potential from labour created in the EPZs of the 1960s and 1970s. They state that, “there is nothing to indicate that the major problems confronting the underdeveloped countries can be solved through world market oriented industrialization, even if the process were to advance rapidly” (Ibid.). They come to this conclusion because the wages paid are too low for reproduction, the creation of job opportunities is limited to specific demographic groups (mostly young women), and there is little skill acquisition because of the deskilling process used in Taylorist production methods (Ibid.).

Furthermore, from an industrialization perspective, potential for national development is *limited for a number of reasons*. First of all, there are few backward and forward linkages with the domestic market⁷. Secondly, technology transfer is limited because research and development often happens offsite and work involving complex techniques or high technology is often controlled by foreigners. Thirdly, profits are repatriated to the country where the firm is headquartered. Fourthly, developing countries

⁷ A backward linkage refers to a domestic input such as raw material used in the production process. A forward linkage is something that is produced and used as an input in a domestic market.

often use state funds to provide infrastructure for the creation of EPZs and these investments are rarely recovered due to the low tax structure applied to firms operating in these zones (Ibid.).

NIDL theory remains a useful tool for interpreting the change of labour processes that took place in the 1960s and 1970s. Today, the theory is useful for interpreting the lengthening global production chain used in producing manufactured goods and the implications this has on labour. EPZs, especially in the Kenyan context, represent an extreme lengthening of the production chain as the inputs for production are almost exclusively sourced outside of the domestic market and the finished product is exported predominantly to the global North. There is little incentive for manufacturing firms to pay a wage that would allow workers to purchase the product they produce because the majority of the products are consumed in export markets.

Employment in Export Processing Zones

Creating employment is an essential aspect of an effective industrial strategy and more broadly an overall development strategy. As a result, developing country governments have cited employment creation as one of the core objectives of EPZs (EPZA Kenya 2011). However, employment creation is one of the most debated issues in EPZ literature and is the focus of much discussion in both academia and among popular media and civil society organizations. The discussion of EPZ employment in this section will not be able to address all of the debates that relate to this topic. The literature on this subject is voluminous and varied, and I will not be able to adequately address all of the

literature because much of it falls outside the scope of the research question and requires a much broader and lengthier discussion to do the subject justice. Nonetheless, this section will address the discussion on EPZ employment as it relates to its impact on industrialization and development.

The literature on EPZ employment is grouped into three separate categories. The first category of literature takes the view that EPZs provide employment that would not otherwise exist if EPZs were not created. Furthermore, this “status quo” approach suggests that this employment is contributing to broader development objectives by providing skills and income to workers in EPZ firms.

The second category of literature is a reformist approach to EPZ, which holds that EPZs have the potential to provide employment, but only if specific regulations are implemented and enforced with regard to workers’ welfare. Generally, the reformist view is that most EPZs do not currently provide employment that furthers development objectives, but that it is possible if governments develop and enforce national and international regulations.

The last category of literature to be analyzed is the most radical view on EPZ employment, which argues that EPZs are unable to provide employment leading to development because the EPZ model is dependent on labour intensive, low skill, and low wage employment and that any attempt to improve the quality of employment would erode the advantages of an EPZ. This literature supports the development of alternatives to EPZs, such as a renewed focus on domestic industry.

The Status Quo

The supporters of the current EPZ model, with relation to employment, view any attempt to regulate labour standards as market distorting. This group includes those that adhere strictly to neo-classical economic principals. The World Bank has explicitly supported this view during the 1980s and 1990s. For example, the 1995 World Development Report entitled *Workers in an Integrating World* exemplifies the commitment of the WB to neo-classical economics in relation to employment. The report states that,

The benefits enjoyed by labor in fast-growing economies are not the result of job creation in the public sector or wage increases mandated by government. Expanding employment opportunities and rising wages are the consequences of growth and economy-wide increases in output per worker. A market-based development strategy achieves these outcomes through investment decisions by firms, households, and government (World Bank 1995: 18-19).

In specific relation to EPZs, the WB, in the same report, admits that there are concerns about the fluid nature of capital investments, particularly in textiles and footwear; however, the WB states that overall job creation in EPZs is better than the alternative of not creating any employment at all (Ibid.: 62). The WB believes that EPZ jobs are the first step on a ladder towards higher value manufacturing and eventually better paying jobs, as domestic firms mature and become more productive due to a liberalized market: “Low skill jobs must be seen as just one step in the growth dynamic” (Ibid.: 62). A number of neo-classical economists have articulated the same viewpoint on EPZs and employment as the WB. For example, Stanford economist Robert Flanagan makes the

argument that EPZ jobs provide better working conditions than jobs outside of the EPZ because EPZs need to compete with other forms of employment because they would fail to attract workers if this were not the case (Flanagan 2006: 177). Using neo-classical economic theory, Flanagan's argument is entirely logical; EPZ firms would have to increase wages and improve working conditions to attract workers if wages and conditions in employment outside the EPZ were better. However, for many workers, EPZ employment is the only option for employment; there is no alternative. Furthermore, Flanagan's analysis fails to take into consideration the public funds used by the government to subsidize EPZ firms (e.g. tax incentives, subsidized electricity, publicly funded infrastructure) and the employment these public funds could create if they were directed into other employment strategies.

However, the status quo view remains the dominant view of the WB, neo-classical economists, and governments that develop EPZs.

The Reformist View

Organizations like the International Labour Organization (ILO), some trade unions that are active in EPZs, and several human rights organizations support the reformist view on EPZ employment. These organizations generally adhere to the principle of 'decent work' which frames 'decent' work as a human right. The reformists do not necessarily take issue with the creation of EPZs, but rather seek to improve the welfare of workers in EPZs through creation and enforcement of international and national labour regulations.

According to the ILO there are four broad themes in ensuring that workers are engaged in decent work. The first of these themes is ‘job creation’. The ILO suggests that in order to create jobs adhering to decent work, there must be “an economy that generates opportunities for investment, entrepreneurship, skills development, job creation and sustainable livelihoods” (ILO 2010a). The second theme, ‘guaranteeing rights at work’, entails making sure that workers are represented, that they are able to participate in making their views known, and that labour laws work in their interest (Ibid.). The third theme, ‘extending social protection’, involves, “ensuring that women and men enjoy working conditions that are safe, allow adequate free time and rest, take into account family and social values, provide for adequate compensation in case of lost or reduced income and permit access to adequate healthcare” (Ibid.). The fourth theme, ‘promoting social dialogue’, is articulated as, “Respect for the fundamental rights of freedom of association and collective bargaining; strong independent workers' and employers' organizations with the technical capacity and knowledge required to participate in social dialogue; political will and commitment to engage in social dialogue on the part of all parties; [and] appropriate institutional support” (ILO 2010b).

Using this framework as a starting point, many NGO's, unions, and individuals have advocated for reforms in line with the decent work agenda. These groups believe that EPZs have the ability to provide decent working conditions if such reforms were enacted and enforced by international and national governing bodies.

In response to pressure from activist groups demanding reforms, major North American and European retailers have adopted more rigorous sourcing codes from their

suppliers that seek to ensure that minimum labour standards are being met. However, the length of the global production chains and the pressure on retailers to reduce costs to consumers makes the enforcement of these codes of conduct difficult. People and groups adhering to the radical view suggest that the current globalized system of production and consumption, based on neo-classical economic principles, is incompatible with providing employment adhering to decent work principles in EPZs.

The Radical View

Those that hold the radical view of EPZ employment call for the abandonment of EPZs in favour of alternative employment creation strategies that focus more on local industries instead of chasing FDI and producing manufactures for distant export markets. The 'radicals' believe that EPZs are unable to provide decent employment and working conditions because they are structured in such a manner that makes decent working conditions impossible. For example, Herbert Jauch, a supporter of the labour movement in Namibia and Southern Africa, argues that the employment created in EPZs, particularly in Southern Africa, comes at the expense of workers' rights (Jauch 2002). Jauch suggests that EPZs cannot be reformed to improve the welfare of workers in a substantial manner because EPZ firms are only interested in manufacturing in locations with the lowest labour costs. This results in a 'race to the bottom' which pits countries in Southern Africa in a competition against each other to lower their labour costs thereby undermining the objectives of regional cooperation and improved livelihoods for the region's workers (ibid.: 110). This argument runs counter to the position of those that

take the 'status quo' position and their belief that EPZ labour-intensive employment will eventually lead to higher value manufacturing. The radical view also discounts the ability of the reformers to achieve their goal because any attempt at improving working conditions in a substantive manner would drive EPZ firms to a lower wage jurisdiction.

In some regards the radical view and the status quo share some commonalities in that both viewpoints see efforts at legislation and enforcement of labour conditions as futile. The radicals and the status quo both believe that the most sustainable method for improving labour conditions is for firms to transition into more productive manufacturing, the difference is that the status quo believes that EPZs are the tool for achieving this goal whereas the radicals see EPZs as a mechanism that is structurally incapable of leading to higher productivity because of its reliance on cheap labour, and manufacturing processes that are disconnected from the domestic economy.

Conclusion

This literature review evaluated different theories of industrialization to determine what impact they had on development objectives of increased exports and diversification of manufactured products, strengthening of the domestic manufacturing sector, and increased and better quality employment in the formal sector. The first part of the literature review focused on theories of industrialization and development by exploring ISI and EOI, as well as interpretations of the developmental state model. The second part of the literature review focused on labour and development with a particular emphasis on industrialization.

The literature on industrialization and development suggests that the current neo-classical economics approach to industrialization is unable to fulfill the development objectives under consideration. The industrialization process that took place in the NICs provides evidence that these countries used many state-led policies of industrialization instead of solely relying on the free market to succeed in achieving their development objectives. The NICs actively promoted, and in some cases protected, their domestic manufacturers to transform their industrial sector.

Current development plans in many African countries, developed with World Bank and donor country approval, explicitly avoid state interventionist policies in relation to industrialization and use the language of market competitiveness to promote market-led policies (Cammack 2009). Neo-classical economic theory has delegitimized the state as a tool for active industrial policy. Rick Rowden comments on this delegitimization, stating,

By the 1990s, the idea that states should play a proactive role in supporting the development of domestic industry had become decidedly unfashionable...Rather than focus on 'national' economic development, the new mantra became 'integration with the global economy' as the route to development...full-blown industrial policy was off the radar. Terms such as 'trade protection', 'subsidies', 'capital controls' and other forms of 'industrial policies' came to be met with derision and disdain. Anyone from those in the aid agencies to the recipient African ministries interested in advancing their careers or getting more foreign aid for their governments learned to quickly dispense with such terminology (2010: 504).

Policymakers have relegated the role of the state to funding infrastructural projects and basic social programs such as health and education, but any discussion about the state

taking a more active role in industrialization is met with resistance by citing past examples of mismanagement, corruption, and inefficiencies in industrial parastatals. However, State-led industrialization policies in South Korea, Taiwan and other NICs suggest that the state can employ a more interventionist role in economic development and be successful (Amsden 2001; Chang 2006, 2007). Considering the divergent views on industrial policy between the mainstream neo-classical economics approach used by institutions such as the World Bank and the revisionist approach used by Amsden and Chang in reference to the NICs, this thesis will examine the extent to which Kenyan industrial policy embodies the mainstream approach, or diverts from it, and the impact that this has had on their industrial development through the study of EPZs. This will require examination of the EPZs effect on overall exports, impact on the overall manufacturing sector through linkages with domestic firms, and the type of products being produced in the EPZ.

The literature on labour and development showed the transformation of labour from Fordism, which primarily focused on production for domestic markets, to globalized production chains, where workers produce manufactures for export markets. The transformation in production, according to the critics of neo-classical economics, means that there are fewer incentives for manufacturing firms to pay higher wages due to increased fluidity of capital and the employment of workers who no longer consume the goods they produce. The status quo approach to employment, as discussed earlier, suggests that open markets and free trade will eventually lead to better employment opportunities as manufacturing firms are forced to become more efficient and productive

to compete in a global market because it allows countries to specialize in production in which they hold a comparative advantage. The radical view suggests that open markets and free trade, as embodied in EPZs, will lead to a race to the bottom, whereby global capital can move freely to the jurisdiction with the best tax incentives, cheapest labour, and ultimately lowest costs of production. Considering the case of Kenyan EPZs, this thesis will seek to determine what effect fluid foreign capital and globalized production is having on EPZ workers and how this relates to labour theory. This will be achieved through data collection on employment creation in EPZs (specifically full-time permanent employment), wage rates, and the quality of employment.

Thesis Statement

The hypothesis argues that the Kenyan EPZ program fails to achieve increases in exports and diversification into higher value products, closer backward linkages with domestic manufacturers thereby strengthening the industrial sector, and increases in the quantity and quality of employment in the formal sector. The EPZ program will not significantly increase exports or diversify into higher value exports because EPZs are based on low cost, low skill production which offers no competitive advantage in higher value and more highly skilled production. EPZ firms can also relocate to other jurisdictions easily because they are not capital intensive and they do not require a highly skilled workforce. The EPZ program will not create closer backward linkages between domestic firms and EPZ firms because EPZs are designed to produce goods for export markets which means that most domestic manufacturers producing for the domestic

market have little incentive to gear their production to provide inputs for high turnover EPZ firms that frequently move from country to country in search of better incentives. In addition, the predominantly foreign ownership of EPZ firms means that most profits are repatriated outside of the country and not reinvested in the local economy. The EPZ program will also fail in significantly increasing the quantity and quality of employment in the formal sector because EPZ firms are reliant on cheap labour to produce goods and they can easily move to lower cost jurisdictions if wages increase.

The EPZ program will fail to achieve these objectives because it is detached from an industrialization strategy that prioritizes domestic needs. The EPZ program represents an entrenchment of neo-classical economic theory that prioritizes free movement of global private capital, low transaction costs, and a limited role for the state in industrialization. These priorities are at odds with the industrialization success of Newly Industrializing Countries that used state-led policies to protect infant industries using a variety of policies such as tariffs, cheap credit, investment in research and development, and in some cases state ownership of enterprises.

Methodology

The research for this thesis was conducted using a case study approach. The Kenyan EPZs are the subject of this case study. I conducted fieldwork in Nairobi and surrounding areas from June 1-August 31, 2010. The majority of the data was gathered during this period. I undertook most of the fieldwork with the cooperation of the Labour Awareness and Resource Centre (LARC), a labour rights organization, as part of a

research internship. This internship was part of the Students for Development program coordinated by the Association of Universities and Colleges of Canada, with funding from the Canadian International Development Agency.

Data Identification

Several types of data were collected in the study of Kenyan EPZs. The data used for this case study can be divided into three categories: export and import data, data on linkages between EPZ firms and domestic firms, and employment data. These three categories of data correspond with the three core objectives of the Kenyan EPZ program: increases in exports and diversification into higher value products, closer backward linkages with domestic manufacturers thereby strengthening the industrial sector, and increases in the quantity and quality of employment in the formal sector.

The data collected on exports and imports includes overall export and import figures of the Kenyan economy in order to provide some context with regard to the main products that the country exports and imports. Current import/export data as well as historical data was used to identify trends in imports and exports in various sectors. The historical data was drawn from secondary sources such as books and articles on the Kenyan economy; Chapter 2 (background chapter) discusses this data. The contemporary import/export data (2000-present) was drawn from primary sources consisting of statistical data published by the Government of Kenya through the Kenya National Bureau of Statistics.

Export data from the Kenyan EPZs was also collected and analyzed. This data consists of exports by sector, export destinations, and value of exports from EPZs. The majority of this data was gathered from annual reports published by the Kenyan Export Processing Zone Authority (EPZA). These reports are yearly summaries of the overall economic performance of the EPZs.

Data on linkages between domestic firms and EPZ firms was collected from a variety of primary and secondary sources. This data consists of the monetary value of goods and services purchased by EPZ firms from the local economy. The primary sources consist of data published by the Kenya National Bureau of Statistics and annual reports published by the EPZA. Other primary sources include a formal interview conducted with an EPZA communications officer as well as informal conversations with representatives from the Kenyan Association of Manufacturers (KAM). Secondary sources are drawn from Kenyan newspapers such as *The Daily Nation* and *Business Daily*.

Data on overall employment in Kenya is gathered from the Kenyan Institute for Public Policy Research Association, the Kenyan National Bureau of Statistics, and the IMF. This data consists of the overall employment rate, employment by sector, and percentage of employees engaged in formal and informal employment. This data provides an overall picture of employment in Kenya and how it relates to employment in EPZs. Data on employment creation and the quality of employment in EPZs was collected from primary sources from the Kenyan National Bureau of Statistics and annual reports from the EPZA. The data from these sources consists of overall employment numbers from

2002-2009 as well as wage rates over the same time period. In addition, I formally interviewed a former EPZ employee, a communications officer from the EPZA and engaged in informal conversations with other current and former EPZ workers. These interviews and informal conversations provided information on issues such as casual employment in EPZs, union-employer relationships, and health and safety compliance. An internal report by LARC from a focus group study with EPZ workers was also consulted. This report contained information from workers on wage rates, overtime pay, safety issues, and purchaser compliance protocol.

Apart from the data collection used specifically for three main objectives, a significant amount of time was also spent at LARC, conducting research on labour relations in the EPZ and on the African Growth and Opportunity Act (AGOA). The majority of EPZ products are exported to the United States under AGOA, making this agreement important for understanding some of the underlying sociopolitical factors that influence exports from the EPZ. The culmination of the research on AGOA was a presentation that I gave to various stakeholders and a subsequent discussion of AGOA and its impact on the Kenyan economy and the EPZ sector specifically. The participants of this presentation and discussion included LARC, the Kenyan Human Rights Commission, EPZA, Kenyan Association of Manufacturers, as well as representation from the Kenyan ministry of trade. This discussion provided a useful insight into issues of EPZs from stakeholders from varying viewpoints.

Methodological Approach and Limits to Study

The case study of Kenyan EPZs is a qualitative study. Data was gathered from a variety of primary and secondary sources as previously discussed. I chose to use a combination of primary documents, secondary sources, and interviews in an attempt to triangulate the data so that it was as accurate as possible. Being able to conduct field research in Nairobi was also an invaluable asset in gathering data that would not have been possible otherwise, particularly engaging in interviews and informal discussions with various stakeholders. However, all research has limits, and the research conducted for this case study is no exception.

One of the most significant limits to this study was the inability to interview a greater number of current employees in the EPZs. It was difficult to interview employees because they work long hours during the week and many of them also work on Saturdays, this leaves employees with little free time for interviews; the majority of employees are young women whom also have family responsibilities. As a result of this limit, there is less information on working conditions in EPZ factories than I had originally intended.

Another limit to this study was the inability to pinpoint the exact owners of each EPZ firm, their financial background, and the way that funds were moving into and out of firms. Many firms in the EPZ are privately held and those who hold this information are reluctant to divulge it. This information would have added some useful insight into the profitability of firms, and how the profits are used.

A significant limit impacting the analysis of linkages between EPZ firms and domestic firms was the way that this data was published by the government of Kenya.

The data includes all of the local goods and services purchase by EPZ firms and this data is not broken down any further. Therefore, there are no specific numbers on how much is spent specifically on utilities, labour, shipping, maintenance etc. This limit made it difficult to analyze the specific linkages between EPZ firms and domestic manufacturing firms.

Last but not least, there were limits to my time and finances in conducting this study. A larger study with a greater number of interviews from participants not only in Kenya but participants connected to EPZs in other African countries would have been useful for comparative purposes.

However, despite the limits, I feel that the information and analysis of this information is accurate and makes a useful contribution to the study of industrialization and development in Kenya.

Chapter 2

Kenya's Industrialization Policies

This section of the thesis provides background information on industrialization policies in Kenya from the colonial era to the present. The objective of this chapter is to provide insight into the particular way in which the government of Kenya introduced and implemented industrialization policies. Specific emphasis is given to the external and internal factors that shaped Kenya's industrial policy. These factors are significant because it shows areas of confluence and tension between domestic influences, such as indigenous manufacturers and politicians, and external influences such as foreign investors, donor countries, and International Financial Institutions (IFIs). The interaction between these various influences is still at work in contemporary Kenya and plays an important role in shaping contemporary industrial policy, specifically in relation to EPZ development.

This chapter also shows how Kenya's industrial policies changed to reflect the change in mainstream development theory, discussed in the literature review, from state-led industrialization policies in the 1960s and 1970s to market-led industrialization policies in the 1980s and 1990s. Although, many of the state-led industrialization policies were problematic, as discussed in the second section of this chapter, the liberalization policies in the industrial sector have done little to stimulate the sector. This chapter shows that EPZs are simply a continuation of liberalized industrial policy.

The chapter is divided into three distinct sections. The first section examines the influence of colonialism on industrial development in Kenya. The second section

explores the industrialization policies implemented in the early post-independence period and the emphasis on growing an indigenous manufacturing sector, through state interventionist policies, to replace imports. The third section analyzes the change from the emphasis on domestic manufacturers and inward looking industrial policies to outward looking policies and an increased emphasis on attracting FDI. This section also examines the effect of Structural Adjustment Policies on industrialization.

Colonial Impacts on Industrialization

Before WWII there was some limited industrial development, mostly in agricultural processing, but most of the industrialization under the colonial administration began during the war and continued into the post-WWII era. Prior to WWII, the British economic policy in Kenya focused on extracting raw materials for British manufacturing industries; there was a deliberate effort to prevent the development of a manufacturing industry in Kenya (Ogonda 1992:161). This policy was consistent with the way that Britain treated most settler colonies at the time; the primary objective was to extract raw materials cheaply from the colonies so that manufacturers in Britain could keep their costs down and increase their profits. The colonies also provided an export market for British manufactured goods.

However, a significant change in the colonial administration's approach to industrial policy in Kenya took place during and after WWII. The war made it difficult for Britain to ship goods to Kenya because of the threat of attack on merchant ships. The shortage of consumer and capital goods in Kenya began to threaten the growth of the

economy, so it became necessary to begin manufacturing some products locally to ease the shortages and strengthen the economy (Ibid.: 164). By the end of the war, Kenya was producing items such as cooking oil, margarine, soap, shoes, bicycle tires, and bicycle tubes (Ibid.: 165). The state-backed East African Industrial Management Board, whom directly owned plants and equipment, funded and supported many local manufacturers (Fahnbulleh 2006: 36).

After the war ended, the policy of increasing local manufacturing continued because large multinational corporations such as Unilever wanted to take advantage of cheap labour in Kenya (relative to the cost of labour in Britain). Furthermore, the Labour Party had come to power in Britain and it was keen to develop new industries in Britain's colonies. The British government provided government backed loans to private firms through the Industrial Development Corporation (IDC) in an effort to encourage firms to invest in new industrial projects in the colonies; the IDC took over many of the functions previously performed by the Industrial Management Board with regard to supporting and assisting the private sector (Swainson 1980: 121-22). The IDC acted as a finance agency: "It prioritised projects that would contribute to the ultimate good of the colony, that would be self-financing, that were not in direct competition with existing private enterprises, and where the possibility of loans from other lending agencies had been exhausted" (Fahnbulleh 2006: 36). Apart from the IDC, the colonial administration used other strategies to encourage private sector involvement in industrialization. These strategies included tax incentives, industrial licensing, industrial research, selective

custom duty refunds, some ad hoc tariff protections, provision of buildings in industrial estates, and allocation of industrial land (Fahnbulleh 2006: 36; Ogonda 1992: 165).

Many of the industrial strategies employed by the colonial administration in the post-war era contributed significantly to the growth of industry in Kenya. By 1963, the manufacturing sector employed 50,000 people in urban areas and between 10,000 and 15,000 people in rural craft industries (Ogonda 1992: 165). Manufacturing accounted for about 10.4% of GDP by 1964 (Leys 1975: 277). Although the manufacturing sector in Kenya was relatively small compared to industrialized countries, it was much larger than most newly independent African countries in the same era. Most Sub-Saharan African countries, apart from Belgian Congo and Southern Rhodesia, had manufacturing sectors that accounted for 2.5% to 6.5% of their GDP (Fahnbulleh 2005: 30). However, even though Kenya had a significant manufacturing sector, the vast majority of the sector was owned and controlled by Europeans and Asians: "...of the total nominal company capital registered between 1946 and 1963, 68% was European, 21% Asian, 11% combined Asian and European and less than 1% African" (Ogonda 1992: 168). The fact that Africans controlled such a small share of the industrial sector had a significant impact on the drive to 'Africanize' the economy in the early post-colonial era.

Despite the lack of African ownership in the industrial sector, Kenya was still much better positioned than many other newly independent African countries in terms of industrialization. The industrial policies implemented by the colonial administration provided Kenya with an industrial base, even though these policies were implemented to

benefit the British. This industrial base was a strong contributing factor to the growth in Kenya's industrial sector in the early post-independence period.

Independence: Africanizing the Industrial Sector

In the early years of independence, Kenya embarked on a development strategy that emphasized infrastructural and social spending; the government wanted to create a welfare state similar to what was taking place in several European countries and North America at the time. The government's three main development objectives during this time were "growth, equity, and Africanization of the economy" (Mwau & Handa 1995: 7). The type of government intervention that the official development plan promoted was "a mixed economy in which strategic and essential resources and services, such as railways and harbours, principal roads, airways, broadcasting and post and telecommunication, would be government responsibility" (Ochieng 1992: 264-265).

In terms of industrial strategy, Kenya focused most of its support on facilitating private sector growth through investment in infrastructure, access to credit, and protecting domestic industries through tariffs and industrial licensing (Fahnbulleh 2006: 38). For the most part, Kenya's industrialization policies in the post-independent era did not differ substantially from those implemented under the colonial administration in the post-war period. Kenya did not adopt the more radical state interventionist industrial policies being practiced at the time in Tanzania and other newly independent states in the region under the banner of 'African Socialism'. Instead of implementing radical state interventions, Kenya strongly encouraged the involvement of foreign private capital in

the industrial sector. The Foreign Investment Act of 1964 allowed foreign investors to apply for a 'Certificate of Approval Enterprise' that, "guaranteed the right to repatriate profits, loans, interests on their loans and the approved proportion of the net proceeds of sale of all or part of the approved enterprise. They were further assured against nationalization" (Ogonda 1992: 304). The encouragement of foreign capital in the industrial sector meant that the ownership structure changed very little after independence; most of the industries were still owned and controlled by foreign investors.

However, from a macroeconomic view, the industrial strategy of the early post-independence era served Kenya well. Between 1964 and 1972 GDP grew at an annual average rate of 6.8% and after accounting for population growth, GDP grew at a rate between 3.5% and 3.8% annually (Hazlewood 1979: 24). The manufacturing sector also performed well during this era, growing by 7.5% per year between 1964 and 1970 (Sharpley & Lewis 1990: 207).

Beginning in the late 1960s and continuing into the 1970s, Kenya took a more radical approach towards industrialization. The state began getting more directly involved in the industrial sector, and a greater emphasis was placed on growing the sector (Fahnbulleh 2006: 39). The government believed that an increased emphasis on industry would diversify Kenya's economy away from agriculture and help the country achieve its ambitious development plans by substantially increasing government revenues to pay for the increase in social spending. The 1970-1974 development plan budgeted 720 million pounds to be spent compared with 430 million pounds being spent in the first

development plan; the plan earmarked much of the new money to be spent on large public infrastructure projects such as roads, water, and education (Gatheru 2005: 195). More importance was also placed on the growth of the industrial sector because there was a growing unemployment problem and the government wanted to increase the participation of Africans in the sector. Kenya's population was increasing rapidly and the agricultural sector was unable to absorb the growing labour pool even after agricultural resettlement schemes had been implemented to increase the number of smallholder farms.

The government began a more aggressive push to industrialize and 'Africanize' the sector by implementing a number of different policies. One such policy was the *Trades Licensing Act* of 1967; initially this legislative act excluded non-citizens from trading goods such as maize, rice, and sugar in rural and non-central urban areas; the Kenya National Trading Corporation (KNTC) granted distribution rights to citizen wholesalers for these products (Swainson 1980: 187). In the 1970s the list of goods covered under the *Trades Licensing Act* was expanded to include salt, soap, shampoo, sweets, matches, batteries, insecticides, hardware, cement, wire, and tools (Ibid.: 187). In 1975 the government amended the *Trades Licensing Act* so that all goods manufactured by foreign firms in Kenya had to be distributed through KNTC appointed citizen agents; the government granted a few exemptions for semi-finished products used as inputs in other industries as well as highly technical manufactured goods (Ibid.: 189). This policy had the effect of 'Africanizing' a greater percentage of the wholesale distribution of manufactured goods in Kenya. However, the policy was not without problems. Many established Asian traders had become Kenyan citizens and were able to qualify for trade

licenses (Leys 1975: 151). As a result, many of these Asian traders competed with Africans for trade licenses and prevented the desired level of Africanization in the sector that the government had hoped for. Furthermore, the *Trades Licensing Act* encouraged African traders to make profits through monopolizing the distribution of goods without adding any value to the goods being traded (Ibid.: 156). There was also tension between the government's policy of reducing imports in favour of local manufactures and the desires of African traders whom held trade licenses for imported goods, often the most lucrative and stable forms of trading available to African traders (Ibid.: 158).

The government also enacted policies to increase the domestic production of manufactured goods as well as increase the percentage of African owned firms and Africans involved in management of foreign owned firms. One of the first significant state interventions in the industrial sector was the creation of the New Project Committee (NPC) in 1968. The NPC began reviewing all of the applications by foreign companies wanting to invest in Kenya. The NPC negotiated duty exemptions, percentages of government shareholding, Africanization of management, technical fees, and other state protections through import tariffs and other methods (Ogonda 1992: 304).

The government developed the Industrial Estates Programme in 1968, in an effort to increase the number of Kenyan entrepreneurs involved in industrial production. Additionally the government wanted to establish industries that were believed to be essential for Kenya's development objectives (Fahnbulleh 2006: 39). The Industrial and Commercial Development Corporation (ICDC), the successor of the IDC, chose projects based on their potential for import substitution and their multiplier effect on industrial

development and training of technical personnel (Ibid.: 39). The ICDS select projects such as, “a foundry for the production of quality casting, diesel engines, pumps, agricultural implements, electric motors and generators; a plant for the manufacture of small lathes, bench drills and bench grinders; the manufacture of spare parts for cycles and automobiles; and the manufacture of sewing machines” (Ibid.: 39).

The more interventionist approach by the state towards industrialization, through the policies mentioned, led to the government either wholly owning or holding a controlling interest in companies in almost every major industrial sector by the mid-1970s. For example, in 1976 the government owned or had a controlling interest in companies in agricultural processing, power generation and distribution, oil refining, cement making, fertilizer manufacturing, mining, and textile manufacturing (Swainson 1980: 246-47). In addition, the government also held a minority interest in companies involved in battery and electronics manufacturing, ceramics, plastics manufacturing, beer brewing, tire manufacturing, pulp and paper manufacturing, leather making, and shoe manufacturing (Ibid.: 248-49).

The interventionist industrial policies pursued by the government during this period were successful in meeting some of the objectives set out in the development plan. Overall GDP grew at a rate of almost 6% per year between 1970-1975 and the manufacturing sector grew by over 7% per year during the same period (Sharpley & Lewis 1990: 207). There was also some success in Africanizing the industrial sector through the use of the *Industrial Licensing Act*, the approval of projects through the NPC, and the creation of the Industrial Estates Programme.

Although there were some policy successes during this period, there were also some fundamental shortcomings. For example, real wages in the manufacturing sector declined in Kenya between 1970 and 1975 compared with significant growth in real wages in the sector between independence and 1970 (Sharpley & Lewis 1990: 220-221). In addition, high unemployment persisted despite government attempts to address this problem through more rapid industrialization. Academics such as Raphael Kaplinsky and Steven Langdon also argued that Kenya failed to successfully Africanize the industrial sector and create an indigenous capitalist class independent from foreign capital; these criticisms became the source of much debate in the 1970s and early 1980s (Leys 1996: 143-163). By the mid-1970s other more fundamental problems began to threaten Kenya's industrial model.

In the mid to late 1970s Kenya was faced with significant challenges that forced the country to radically alter its industrial strategy. Initially, the government attempted to use more state-led intervention to address the challenges but a number of factors forced the government to abandon these policies. Chief among the challenges was a growing balance-of-payments deficit. The manufacturing sector was importing increasingly expensive machinery and the cost of importing oil was soaring due to the oil crisis of the 1970s; the cost of importing oil increased to such an extent that 40% of Kenya's export earnings were used for purchasing petroleum (Miller & Yeager 1994: 128; Ogonda 1992: 308). In contrast to the increasing price of imports, Kenya's revenues from its main export earners of tea and coffee remained relatively stagnant during the same period,

apart from a temporary coffee boom from 1976-1978 (Mwau & Handa 1995: 10; Ogonda 1992: 308).

The collapse of the East African Community (EAC) in 1977 further compounded Kenya's balance-of-payments deficit⁸. Prior to the break-up of the EAC, Kenyan manufacturers exported a significant proportion of their products to Uganda and Tanzania. However, after the collapse of the EAC, Kenyan manufacturers exported a fraction of what they had previously been exporting to these countries. The loss of these export markets for Kenyan manufacturers was a significant loss and Kenya lacked a large internal market to replace the demand.

The government of Kenya responded to these challenges by taking a more radical and interventionist approach in the economy. For example, the government banned some imports in an effort to try and balance the trade deficit and restricted some overseas travel (Miller & Yeager 1994: 128). The boom in prices for coffee and tea from 1976 to 1978 briefly reversed the country's growing deficit problem by dramatically increasing government revenues and foreign exchange reserves. This reversal in fortune spurred a significant jump in government social spending, an increase in external borrowing, and construction of new plants in the industrial sector (Ogonda 1992: 308). With renewed confidence from the commodity boom, the government announced an ambitious

⁸ The EAC was established in 1967 to promote regional cooperation and integration between Kenya, Tanzania, and Uganda. Examples of regional initiatives under the EAC included the University of East Africa, East African Airways, and the East African Income Tax Department. However, the member countries of the EAC grew apart due to ideological differences and a belief on the part of Tanzania and Uganda that Kenya enjoyed an unfair trade advantage over them because of their more advanced economy and other strategic infrastructural advantages (Mugomba 1978: 264).

development plan for the years 1979-1983. Under the new political leadership of Daniel arap Moi, the plan called for the creation of one million new jobs, investment in new industries, and increased social spending to reduce poverty. However, the launch of the plan coincided with a dramatic drop in the price of coffee and tea, coupled with a decrease in agricultural production (Miller & Yeager 1994: 127-28). These events devastated the Kenyan economy and forced the country to abandon the industrial policies that it had pursued since independence.

Structural Adjustment: Pressure to Reform

The beginning of the 1980s marked a paradigmatic shift in industrial policy in Kenya due to the economic crisis that began in the 1970s. By 1980 inflation had reached 20% and GDP growth had fallen to less than 3% in 1982; external debt also rose rapidly in the 1980s from 25% of GDP in 1980 to over 50% of GDP in 1987 (Adam, Cavendish, & Mistry 1992: 325). In addition, Western governments and IFIs began applying pressure on Kenya to limit state involvement in the industrial sector in favour of encouraging growth in the private sector.⁹ As a result of the economic constraints and external pressure from international lenders, Kenya scaled back many of the state interventionist policies that it pursued in the previous era. For example, the government halted the construction of new plants in the 1980s due to the inability to fund the projects, coupled

⁹ See page 10 in Chapter 1 for a more in depth discussion of the shift in development ideology.

with a sharp rise in the price for imported machinery because of the Kenyan currency devaluation¹⁰.

Although Kenya reduced state involvement in the industrial sector throughout the 1980s, it never privatized the sector to the extent recommended by the World Bank, International Monetary Fund, and Western donor governments. The policy direction in the industrial sector throughout the decade was much more disjointed than the industrial policy pursued through the 1960s and 1970s. The government, on many occasions, officially committed to privatization and less intervention in the sector to guarantee structural adjustment loans; sometimes steps were taken to enact privatization policies. However, the government, in practice, often maintained the status quo and kept many of the state interventionist policies intact in the industrial sector by refusing to privatize parastatals and maintaining industrial licensing controls.

The Moi government took its first significant step in addressing the economic crisis by commissioning a panel to investigate policy solutions led by economist and central bank director Philip Ndegwa (Miller & Yeager 1994: 129). The Ndegwa Commission recommended that the government should cut subsidies to industry and implement austerity measures to slash spending and reduce reliance on foreign borrowing (Ibid.: 129). At the same time, the IMF was recommending that Kenya should move away from ISI policies in favour of export promotion (Ibid.: 129). The government accepted the recommendations from both the Ndegwa Commission and the IMF, but the

¹⁰ The Kenyan currency was devalued on advice from the World Bank in an effort to make Kenyan goods cheaper for export (Ogonda 1992: 308).

government only implemented some of the recommendations. For example, the government implemented some of the recommendations by sharply reducing the value of its currency to make exports cheaper through a series of devaluations until the currency was worth less than 1/3 of its value in 1990 than it was in 1980 (Ogonda 1992: 308). Furthermore, the government eased some of the quantitative restrictions on imports and abolished the sales tax on imported machinery (Fahnbulleh 2005: 275). However, the government was reticent to privatize industrial parastatals, in spite of pressure from the IMF and donor countries: “At mid-decade [1980s], parastatal corporations accounted for 8 percent of GDP, 55 percent of public-sector capital formation, 31 percent of public employment, and 15 percent of formal-sector employment” (Miller & Yeager 1994: 141).

Kenya continued its state intervention in the industrial sector with the belief that the government still had an important role to play in the sector; the government believed that the solution to the economic stagnation was a reform of some of the state-led interventionist policies instead of a complete withdrawal from the sector in favour of ‘free-market’ solutions. A 1981 letter from then vice-president and finance minister of Kenya, Mwai Kibaki, to the regional World Bank vice-president explains why the government was resistant to widespread free-market reforms:

With regards to your request that a firm timetable be established for carrying out further action towards trade liberalization, we are prepared to take selective steps in this direction, subject, however, to external uncertainties. Kenya’s export potential is highly uncertain with respect to access to markets in neighbouring countries and European nations, in both of which economic growth and trade liberalization are doubtful features. In these circumstances specific commitments on trade liberalization by Kenya are hazardous undertakings (qtd. in Fahnbulleh 2005: 276).

The donor community continued to call for greater liberalization of the industrial sector in Kenya throughout the 1980s, often citing that the reason the economy was faltering was because of the inefficiencies of parastatals and state protected industries as well as rampant corruption within the sector and the government as a whole.

Domestic manufacturers also accused the government of corruption. In the late 1980s, manufacturers of a variety of products such as petroleum gas cylinders, farm machinery, and sisal bags all complained that illegal granting of import licenses by officials in exchange for bribes was hurting their ability to sell their products due to a flood of cheaper imports (Himbara 1994: 123-126). The sisal bag manufacturer collapsed as a result of the imports and 3000 workers were laid off and several hundred farmers in Kenya that supplied raw materials for the bags lost a major buyer (Ibid.: 126). However, the external donors and the indigenous manufacturers had different prescriptions for reforming industrial policy; the external donors wanted to abolish the domestic protections altogether, but the indigenous manufacturers believed that protection from import, in some cases, was necessary to foster a domestic manufacturing industry. The domestic manufacturers wanted a reform of the system to make it more efficient, but not necessarily a complete liberalization of the sector. In 1986 the Kenya Association of Manufacturers developed 8 critiques of Kenyan industrial development (Miller & Yeager 1994: 141-42):

1. There was underused industrial capacity and skills.
2. Redundant investment was flowing into sectors with excess capacity.

3. Failure to move to production of intermediate inputs in line with a more advanced stage of ISI.
4. Lack of a long-range vision on the part of planners for industrialization and development of technological capacity.
5. The need to negotiate better terms with foreign investors and donors.
6. The need to give good incentives to farmers to earn more foreign exchange.
7. The inability of the government to promote local industry.
8. The alliance of local monopolists and traders with some politicians adversely affecting industry.

The critiques outlined above show that there were several issues with industrial policy,

apart from corruption, and that the solutions for the stagnating sector was long term support for local manufacturers, using a variety of policies including protection, and detailed planning. The local manufacturers still wanted competition between firms and called for an end to monopolies in certain sectors but this was not the same position of the external donors whom wanted the entire sector liberalized and made to compete with global competitors.

Although domestic manufacturers and external donors asked the government to reform the industrial sector, it continued with the same advance and retreat policies and failed to address the issue of corruption. The government often implemented liberalization in the industrial sector only to the extent that it would guarantee continued lending from donors, but stopped short of complete liberalization.

By the end of the 1980s Kenya's industrial sector was stagnant. Manufactures made up 12% of Kenya's exports in 1990, an increase of only 2% since 1965 (World Bank 1992: 248). The sector had failed to become competitive internationally even though the currency had been devalued significantly. Many Kenyan manufacturers, particularly in the shoe and textile sector, were also struggling to survive in the domestic market due to cheap imports (Miller & Yeager: 144).

By the early 1990s Kenya's economy was in crisis: in 1992 and 1993 GDP growth was near zero, foreign currency reserves were almost depleted, the banking system was on the verge of collapse, and inflation reached a record high of 46% (Pape 1996; Kenya National Bureau of Statistics 2008). As a result of the poor economic performance, Kenya was growing increasingly reliant on donor aid. The donor community used the increased reliance as an opportunity to force Kenya to implement radical reforms in the industrial sector and the broader economy as a whole. In 1991, the donor community suspended aid to Kenya and stated that it would not resume aid transfers unless the government adopted and implemented a comprehensive structural adjustment program (SAP) (Fahnbulleh 1995: 278-79). The SAP "called for a reduction in personnel in the civil service, the liquidation and/or privatization of most of Kenya's parastatal sector, the devaluation of the Kenyan shilling, and relaxation of the rules regarding repatriation of earnings by foreign investors" (Himbara 1994: 151). After the suspension of aid, Kenya had two policy options: implement the SAP and resume aid transfers or reject the SAP and risk a complete economic collapse. Kenya chose the former option and embarked on a policy of widespread reform across many sectors; by

1995, the government cut 30,000 jobs in the civil service and a massive divestment of non-strategic parastatals was undertaken (Pape 1996). The government also implemented other reforms specific to the industrial sector: the government abolished import licensing, substantially reduced import tariffs, discontinued price controls on commodities, phased out foreign exchange controls, floated the exchange rate freely on international markets, and passed the Export Processing Act to encourage foreign direct investment in the manufacturing industry by granting a ten year corporate tax holiday to investors (Fahnbulleh 2005: 279-90).

Despite the radical reforms, Kenya's macroeconomic performance for the remainder of the decade was mixed. GDP grew again between 1994 and 1996 but the economy entered another period of stagnation between 1997 and 2001, due in part to the suspension of loans by the IMF because of unmet conditions in the SAP with regard to governance reforms (UNDP 2001: 68; Hanmer et al 2003: 179). The manufacturing sector in Kenya also stagnated. Manufacturing as a percentage of GDP remained virtually unchanged from 1990-2000, it accounted for about 13% of GDP (Fahnbulleh 2005: 300). The underwhelming performance of the manufacturing sector in the 1990s is even more apparent when considering that the manufacturing sector accounted for 10.4% of GDP in 1964 (Leys 1977: 277).

Since 2000 the government's development policies have focused on poverty reduction through investments in education and health and reform of the economy to make it more open and attractive to foreign investment; industrial policy has mostly been focused on manufacturing for export. The government's industrial policies focus on FDI

in EPZ development with the intention that EPZs will spur the development of a more sophisticated manufacturing sector engaged in higher value added manufacturing (this will be discussed more thoroughly in the following chapter). The government has published two major development planning policies, also known as Poverty Reduction Strategy Papers (PRSPs). The first PRSP is the Economic Recovery Strategy for Wealth and Employment Creation (2003-2007) and the second PRSP is Vision 2030 (2008-2012).

In 2003 the newly elected National Rainbow Coalition developed the first PRSP. The central objectives of the first PRSP are improved macroeconomic stability, increased access to education and health services, and improved governance (IMF 2005: v). The PRSP makes an explicit commitment to the private sector to meet Kenya's economic growth objectives: "the ERS [PRSP] commits to strengthening the macroeconomic framework, assuming a responsible fiscal stance, and providing a conducive environment for private sector investment in the productive sectors and, specifically, in infrastructure development and maintenance" (Ibid.: 1). The role of the state is one of facilitating private sector growth, through macroeconomic stability and investment in infrastructure, as opposed to the more active state interventions in the economy in the 1970s and 1980s. The PRSP states that,

The [economic] strategy calls for redefining the role of the state as facilitator for private sector growth and investment. This will entail strengthening policy and regulatory functions of the state and transferring productive and service delivery activities to the private sector. Within this framework, the government commits to...implementing mechanisms for private sector participation in provision of infrastructural services, and establishing a competitive environment able to attract increased private

investment in productive sectors such as tourism, industry and trade (Ibid.: 12).

In specific reference to industry, the PRSP acknowledges that the manufacturing sector is performing below its potential. To address this problem the PRSP states that the government will consult with industry to make the sector as productive as possible through improved access to quality training, liberalizing trade, enhancing infrastructure and taking other steps to lower business costs (Ibid.: 50). However, the PRSP falls short of identifying specific goals for the industrial sector, such as listing priority manufacturing activities or setting specific targets for industrial sector growth. The PRSP set some targets for expanding the number of EPZs and improving backward linkages between textile manufacturers and the cotton industry but no specific numbers were given. The underlying assumption in the PRSP is that the private sector will attract the necessary investment in industry if the government provides the infrastructure to lower transaction costs and reduces barriers to trade.

Vision 2030 is Kenya's second PRSP and serves as Kenya's development plan for 2008-2012. The overall objective of Vision 2030 is to make Kenya a middle-income country by 2030.

For the most part Vision 2030 is consistent with the policy objectives introduced in the previous PRSP. Vision 2030 is broken down into three main pillars for development: the economic pillar, the social pillar, and the political pillar. Under the economic pillar, a more detailed strategy for the manufacturing sector is developed compared to the previous PRSP. It recognizes that Kenya's manufacturing sector has continued to

stagnate but Vision 2030 is more prescriptive than the first PRSP by stating specifically that there needs to be an increase of locally manufactured goods for the domestic market: “the share of Kenyan products is only 7 per cent of the US \$11 billion regional market. The Eastern African market is dominated by imports from outside the region. This is an indication that there is a large potential to improve Kenya’s competitiveness in the region by replacing external suppliers gradually” (Ministry of Planning and National Development 2007: 60). Furthermore, Vision 2030 states that, “Weak enforcement of standards and of tax laws has led to dumping of sub-standard imports and counterfeit goods into the domestic market, making it unfavourable for local manufacturers to compete” (Ibid.: 62). The language sounds similar to some of the arguments made in favour of state-supported import substitution policies of the 1960s and 1970s. However, Vision 2030 is devoid of any state interventionist policies in the manufacturing sector such as tariff protection, state financing of industry, or tougher laws to address dumping of sub-standard imports and counterfeit goods. Vision 2030’s policies for improving manufacturing performance consist of improving infrastructure such as highways, rail, ports, and energy distribution systems; boosting investment in science and technology research; and implementing efficiency-enhancing institutional reforms (Ibid.: 63). Apart from the stated goal of increasing Kenya’s share of the regional market, the rest of the manufacturing policies in Vision 2030 emphasize the need to expand EPZs and transition them to SEZs. This will be discussed more thoroughly in the next chapter.

Despite the renewed emphasis on manufacturing in Vision 2030, the sector continues to underperform and has failed to significantly improve its share of GDP,

create more jobs, and move higher up the value chain. Despite these shortcomings the government remains firmly committed to export promotion policies and increased liberalization of the sector. Alternative state-led industrial policies are explicitly omitted.

Conclusion

This chapter has shown how Kenya's industrialization policies shifted from state-led industrialization in the 1960s and 1970s to market-led industrialization in the 1980s and 1990s largely due to pressure from Western country donors, the World Bank, and the IMF in the form of SAPs. Kenya started with a significant industrial base at independence, compared to other African countries, and the sector grew significantly through the 1960s and 1970s using state-led industrial policies. However the sector's share of GDP has remained virtually unchanged since the 1980s. The World Bank and donor countries have effectively reduced the space for the state to intervene in the industrial sector by pushing for the elimination of tariffs, divestment of parastatals, and liberalization of the market. The government of Kenya has adopted and implemented many of these policies despite recommendations from local manufacturers asking for some protection and strategic state involvement in the sector. The transformation from state-led industrialization to market-led industrialization is particularly relevant to EPZ development because the EPZ program represents a steadfast commitment by the government of Kenya to neo-classical economic principles that prioritizes free movement of private capital in and out of the country, low transaction costs, and the reduction of barriers to global trade; although it should be noted that the government has subsidized

the EPZ program heavily in an effort to attract FDI (this will be discussed in more detail in the following chapter). Nonetheless, the government's commitment to neo-classical economics has achieved little in stimulating the domestic manufacturing sector.

Chapter 3

Export Processing Zones in Kenya

This chapter shows how EPZs in Kenya fail to achieve increases in exports and diversification into higher value products, closer linkages with domestic manufacturers, and increases in the quantity and quality of employment in the formal sector. This chapter discusses each of these objectives separately using data and figures from the Government of Kenya, the EPZA, and a variety of other sources. Furthermore, this chapter shows how the Kenyan EPZs are part of a neo-liberal global trading system, through AGOA, that prioritizes open market access, reduction of state intervention in the market, and an industrial policy that favours foreign private capital over state supported domestic manufacturers.

The chapter consists of five sections. The first section is a brief overview of EPZ development in Kenya. The purpose of presenting an overview is to provide the reader with a greater understanding of the overall structure of the EPZ program in Kenya. The second section consists of data analysis on the impact that EPZs are having on exports. The third section discusses the linkages between domestic manufacturers and EPZ firms. The fourth section presents and analyzes data on employment in EPZs. The fifth section considers the future of the EPZ program and its implications for industrialization in Kenya.

EPZ Development Overview

The government of Kenya established the EPZ program in 1990. EPZs consist of privately funded EPZs as well as publicly funded EPZs; the publicly funded EPZs are owned by the EPZA on land that was bought and serviced by the government, and the buildings on the land are leased to private firms. The largest EPZ is the publicly funded Athi River EPZ near Nairobi. It was completed in 1997 at a cost of US\$30 million and was financed with a loan from the World Bank covering 80% of the cost; the government of Kenya financed the remaining 20% of the cost (EPZA 2011). The Athi River EPZ hosts 34 firms and employs over 8000 people (EPZA 2010: Table 4). The other publicly funded EPZ, Kipevu, near the port of Mombassa, is much smaller in size; as of 2009 (the latest date for which data is available) Kipevu hosts 3 firms and employs 30 workers (Ibid.). The remaining 29 EPZs are privately funded; most of these zones host only one firm and the largest, Sameer Industrial Park, hosts six firms and employs nearly 4000 people (Ibid.). The following table shows that the Athi River EPZ has the greatest number of firms, employs the most people, and has the greatest value of exports.

Table 3.1 Operational EPZs in Kenya in 2009

	Zone	No. of firms	No. of jobs	Exports (Kshs)
1	Alpha Logistics Services EPZ Ltd	1	11	66,351,480
2	Ashton Apparels EPZ Ltd(Coast Industrial Park)	2	64	53,791,888
3	Athi River EPZ Ltd	34	8,273	6,962,323,014
4	Ayman Industrial Park EPZ Ltd	1	9	7,480,050
5	Comarco Properties EPZ Ltd	3	257	647,635,247
6	De La Rue Currency and Security print EPZ Ltd	1	367	1,717,688,936
7	Emirates Agencies EPZ Ltd (Changamwe)	3	36	372,222,108
8	Erdemann EPZ Ltd	1	24	41,719,706
9	Gold Crown Foods EPZ Ltd	1	182	777,404,714
10	Hurlingham Group EPZ Ltd	1	6	6,513,694
11	Indigo EPZ Ltd (in receivership)	1	1,966	1,161,188,457
12	Kenya Fluorspar EPZ Ltd	1	242	113,800,412
13	Kingorani EPZ Ltd	4	1,953	33,509,932
14	Kipevu EPZ Ltd	3	30	19,554,606
15	Malory Investments EPZ Ltd	1	7	0
16	Mazeras EPZ Ltd	1	2,322	2,992,847,918
17	Mistry Jadv Parbat EPZ Ltd	0	0	0
18	Mvita Industrial Park EPZ Ltd	1	3,791	1,819,940,451
19	Olivado EPZ Ltd	1	101	10,413,725
20	Penguin Paper & Book Co EPZ Ltd	1	18	37,520,470
21	P.J Dave EPZ Ltd	1	92	483,080,143
22	Plastic Compounders EPZ Ltd	1	39	59,043,498
23	Pwani Industrial Park EPZ Ltd - Changamwe (Kapric)	5	1,787	601,101,841
24	Pwani Industrial Park EPZ Ltd - Miritini (Formerly Birch)	0	0	0
25	Sameer Industrial Park EPZ Ltd	6	3,953	2,944,642,628
26	Saw Africa EPZ Ltd	1	346	227,900,000
27	Sunflag EPZ Ltd (Road C, Ind. Area)	3	74	266,275,291
28	Sunflag EPZ Ltd(Runyenjes Road, Ind.Area)	1	1,618	991,737,504
29	Wildlife Works EPZ Ltd	1	50	662,592
30	Zois EPZ Ltd (Miritini)	1	1,127	868,462,027
31	Zois EPZ Ltd (Mtwapa)	1	1,370	663,352,124
	Total	83	30,115	23,948,164,456

Source: EPZA 2009, pg. 14-16

The EPZ program offers a number of incentives to investors. Tax benefits include a ten year corporate tax holiday and 25% tax thereafter (the current proposal is to reduce this to 15% after the tax holiday); ten year withholding tax holiday on dividends and other remittances for non-resident parties; exemption from Value Added Tax (VAT) and customs import duty on inputs; and 100% investment deduction on investments in new buildings and machinery (EPZA 2011). Other incentives include reduced times for project approvals and fewer bureaucratic procedures; no exchange controls; and serviced land and pre-built factory buildings available for sale or lease (Ibid.).

Although the EPZ program has been in existence since 1990, it only began to receive significant foreign investment after 2000, because of the implementation of the African Growth and Opportunity Act (AGOA); AGOA is a US trade act with Sub-Saharan African countries that guarantees preferential access to the US market for a number of African products. In order to qualify for AGOA, Sub-Saharan African countries must meet a number of conditions. The President of the US deems countries eligible,

If they are determined to have established, or are making continual progress toward establishing the following: market-based economies; the rule of law and political pluralism; elimination of barriers to U.S. trade and investment; protection of intellectual property; efforts to combat corruption; policies to reduce poverty, increasing availability of health care and educational opportunities; protection of human rights and worker rights; and elimination of certain child labor practices (International Trade Administration 2011).

The US granted AGOA eligibility to Kenya in 2000, allowing the country barrier-free access to the US market for a number of products; the most important products for

Kenya, in relation to EPZs, are textile products. After Kenya was granted AGOA eligibility, many Asian investors constructed manufacturing facilities in Kenyan EPZs to produce textile products because many Asian countries, at the time, had quota limits on the export of textiles to the US as part of the Multi-Fibre Agreement (MFA)¹¹.

AGOA is significant, not only because it provides Kenya with a market for export products, but also because it represents Kenya's commitment to neo-classical economics. AGOA represents the continuation of external pressure on the Kenyan government to reform its economy by reducing state intervention; the reward is access to the US economy. In EPZs, the largest beneficiaries of this agreement are EPZ firms, the majority of which are foreign owned, shipping textile products to the US, paying zero tax to the Kenyan government under the tax incentive arrangement, and repatriating their profits without penalty.

Exports and EPZs

One of the principal objectives of the EPZ program in Kenya is to diversify and increase exports (EPZA 2011). The data in this section shows that the contribution from EPZs to overall exports has been limited, and that export products manufactured by EPZ firms have failed to significantly diversify into higher value products; the majority of the

¹¹ The Multi-Fibre Agreement (MFA) provided for the application of selective quantitative restrictions when surges in imports, particularly textiles, threatened to damage the industry of the importing country; the MFA began a phase-out process starting on 1 January 1995 and was replaced by the World Trade Organization Agreement on Textiles and Clothing. The phase-out process culminated in the complete removal of all quantitative restrictions on textile and clothing imports in 2005 (World Trade Organization 2011).

products are made up of textiles and apparel. Furthermore, the value of exports in the textile sector has fallen since the peak in 2004.

This section is divided into three parts. First, an analysis of macroeconomic data provides a brief overview of Kenya's overall exports to show which products constitute the majority of exports. Secondly, I examine EPZ export data in relation to overall exports to show its impact on total export value. Additionally, I present trends in export volumes in the EPZ sector as well as trends in the types of exports being produced to show which products are being produced and exported from EPZs. Finally, there is an overall evaluation of the impact that the EPZ program has made in diversifying and increasing exports.

Kenya's exports grew steadily in the last decade with the exception of 2009, the year the global economic recession began (See table 3.2).

Table 3.2 Kenya's Annual % Growth in Exports of Goods and Services

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
% Growth	1	4	7	7	13	9	2	7	7	-7

Source: World Bank 2011c

Most of Kenya's export growth has come from the export of commodities such as tea and horticultural products (cut flowers), as opposed to manufactured goods. In 2009 the top three export products by value were tea, horticultural products, and coffee respectively; these three exports accounted for almost half of the value of all exports (Kenya National Bureau of Statistics 2010: 124).

However, export growth has not kept pace with the growth in imports, resulting in a significant trade deficit (See table 3.3).

Table 3.3 Kenya's Balance of Trade, 2005-2009 (Ksh million)

Year	2005	2006	2007	2008	2009
Exports	260,423	250,994	274,658	344,947	344,950
Imports	443,093	521,483	605,112	770,651	788,097
Balance of Trade	-182,670	-270,489	-330,454	-425,705	-443,147

Source: Kenya National Bureau of Statistics, 2010, pg. 118

The majority of Kenyan imports are made up of industrial supplies, fuel, machinery and capital equipment, and transport equipment (Ibid.: 132). The value of imported goods such as private automobiles, electronics, clothing, and other consumer goods is also growing in step with Kenya's burgeoning middle class. This means that a growing number of manufactured goods are being imported into Kenya and the growth in value of these imports is much higher than the growth in value of Kenya's exports which continue to be dominated by raw commodities. This type of growing trade imbalance is not a new phenomenon; it has been a problem in developing countries for decades and was a major reason that countries implemented ISI policies in the 1950s and 1960s.

In 2009 EPZs in Kenya accounted for 1.92% of GDP in Kenya and represented 6.94% of the value of all exports; the EPZs also accounted for 3.63% of all manufacturing (EPZA 2010).

Table 3.4 EPZ Contribution to GDP, Exports, and Manufacturing Sector

Year	2002	2003	2004	2005	2006	2007	2008	2009
Gross Domestic product (market prices Kshs Million)	1,025,584	1,055,658	1,109,338	1,172,784	1,248,833	1,335,763	1,357,640	1,392,832
Exports EPZ (Kshs. Million)	9,741	13,812	23,047	20,036	22,893	27,400	28,094	23,948
% of EPZ contribution to Total Kenya Exports	5.75	7.54	10.73	7.69	8.91	9.98	8.14	6.94
% of EPZ contribution to manufacturing sector value of output	3.18	3.85	5.44	4.76	4.42	4.87	4.36	3.63
% of EPZ contribution to GDP	1.08	1.40	2.18	2.03	2.00	2.20	2.29	1.92

Source: EPZA 2009, pg. 29

The data in Table 3.4 show that EPZs are in a downward trend in relation to their contribution to Kenya's total exports, contribution to the overall manufacturing sector, and contribution to GDP. There are two main factors that explain the underperformance of EPZs in relation to exports and a secondary factor that has contributed to this trend.

The first major factor contributing to the downward trend of EPZs in relation to exports, the manufacturing sector, and GDP is the US economic recession that began in 2008 and continued throughout 2009; GDP decreased by 2.6% from 2008 to 2009 in the US (IMF 2011). The US recession had the effect of reducing demand for clothing and textiles from Kenyan EPZs. Goods sent to the US under the African Growth and Opportunity Act (AGOA) trade agreement account for 54% of exports from the EPZs; 98.1% of these were garment products (Ibid.: 31-32). The economic recession negatively

affected demand for clothing and other garment products in the US and this is reflected in the marked drop in exports from 2008 to 2009 in Kenya's EPZs (See Table 3.4).

The second major factor contributing to the underperformance of exports in the EPZs is the expiration of the Multi-Fibre Agreement (MFA) in 2005. The MFA imposed quotas on the quantity of textile products and garments that could be exported from developing countries to developed countries. The MFA worked in favour of Kenya because it was exempt from the quotas, but low cost and high volume producers of textile products, located in countries such as China, were limited in the quantity of textile products that they could ship to developed countries. The protection of Kenya from lower cost producers allowed the textile industry in Kenya to thrive. Many firms constructed textile factories in Kenyan EPZs to take advantage of the quota exemption. However, when the MFA expired in 2005, member countries of the World Trade Organization lifted quota restrictions and many firms closed their operations in Kenya due to increased competition from lower cost production facilities in Asian countries such as China, Bangladesh, Cambodia, and Vietnam (Ibid.: 37). Compared to the rapid growth of the EPZ sector from 2002-2004, performance of the sector has remained relatively stagnant from 2004-2009 as a result of the expiration of the MFA (See table 3.4). The textile sector, specifically, has shown steady declines in export value since 2004 (See table 3.5).

Table 3.5 Selected Indicators for Garment Manufacturers in Kenyan EPZs

Year	2002	2003	2004	2005	2006	2007	2008	2009
Number of Enterprises	30	35	30	25	25	22	18	19
Investment (Kshs million)	6,908	9,710	8,595	9,977	10,317	8,314	7,578	5,490
Exports (Kshs million)	8,149	11,083	17,575	14,688	14,894	13,768	15,811	12,699
Quantity of exports (million pieces)	28.0	42.8	56.3	50.0	46.3	59.6	67.9	58.1
Imports (Kshs million)	5,699	7,121	10,012	8,592	7,674	8,439	9,146	6,443

Source: EPZA 2010, pg. 24

The third factor that has negatively impacted EPZ performance is the high cost of energy for manufacturing firms. The problem becomes particularly acute when water levels drop in hydroelectric dams due to drought. For example, 2009 was an abnormally dry year in Kenya and hydroelectric power generation dropped by 35% compared to the previous year (Ibid.: 7). Kenya increased the amount of thermal generated power to make up for the shortfall but the cost of thermal power generation is significantly higher than hydroelectric power. Increases in costs were passed on to consumers including heavy users such as manufacturing firms. EPZ firms cite high costs for electricity, compared to other countries, as one of the reasons they are unable to remain competitive (Ibid.: 2).

The data from this section has shown that EPZs have failed to significantly increase manufactured exports from Kenya and they have also failed to diversify into manufactured products higher in the value chain. The majority of exports are made up of textiles, and this sector is performing poorly due to increased competitive pressure from lower cost Asian manufacturers. These findings support the argument that EPZ firms are dependent on low cost production that can easily be relocated to jurisdictions with lower cost structures.

Linkages Between Domestic Firms and EPZs

Linkages and technology transfer between domestic firms and EPZs is another core economic objective of the EPZ program (EPZA 2011). The government suggests that EPZ firms will stimulate manufacturing by local firms by using local inputs and transferring technology from EPZ firms to domestic firms. However, this section shows that there are few linkages between domestic firms and EPZ firms because most of the inputs used by EPZ manufacturers are sourced from outside the country. Furthermore, plans to allow EPZ firms to sell more of their product in the domestic market may threaten domestic manufacturers because they do not receive the same government subsidies and are therefore placed at a competitive disadvantage.

In 2009 local expenditures by EPZ firms totaled just over 11 billion Ksh, a 3.1% decrease from 2008 (EPZA 2010: 40; Kenya National Bureau of Statistics 2010: 206); this is equivalent to 142 million US using the average annual exchange rate from 2009 (Ibid.: 117). Local expenditures include “the amount of resources spent by EPZ

enterprises in purchase of local goods and services, purchase of capital goods, salaries for local employees, electricity, telephone, water, rent, transport, and all other local costs” (Ibid.: 206).

Local wages alone accounted for nearly 3.3 billion Ksh spent locally in 2009 (EPZA 2010: 33); this represents almost 30% of total local expenditures. Other significant local costs for EPZ firms are electricity, water, and transport. Kenya’s overall GDP in 2009 was 1.4 trillion Ksh (18 billion US).

The actual expenditures by EPZ firms on locally sourced inputs is a difficult figure to calculate because it is not disaggregated from total local expenditures by EPZ firms in the 2009 annual report. However, when large local expenditures such as wages, utilities, and transportation are factored out, it is reasonable to hypothesize that the number spent on domestic raw materials and manufactured inputs becomes much less significant which suggests that the linkages between firms in EPZs and domestic manufacturers are weak. An example that supports the hypothesis that links between EPZs and domestic manufacturers are weak, is the lack of local materials used in the production of textile products in EPZs. This is a useful example because textile firms in the EPZs account for over half of all EPZ exports by value, nearly half of all sales, and over 30% of local expenditures (Ibid.: 20). However, textile firms source cotton, one of the most important raw materials in textile production, primarily from countries outside of Kenya. Cotton production in Kenya peaked in the mid-1980s at 70,000 bales of lint, but Kenya produced only 23,000 bales in 2009 (Ondari 2010; Wahome 2011). As a result, Kenya does not have the capacity to meet the demand for cotton from textile

manufacturers in EPZs. Many textile firms in the EPZs can secure cheaper cotton from outside the country. However, starting in 2012, Kenya will be required to source all cotton in US destined textile products locally or from the US as part of the AGOA agreement. The government of Kenya and local cotton producers are attempting to revive the cotton industry in Kenya to meet source requirements for AGOA, but it is not certain if Kenya will be able to source all of the cotton required in EPZ textile production to meet these requirements. Furthermore, given the challenges facing textile manufacturers in Kenyan EPZs such as increased competition from Asian manufacturers, declining number of textile firms, and declining value of textile exports (see table 3.5), there may not be a long-term market for local cotton producers attempting to sell their product to EPZ firms. The local cotton industry might be better off focusing its long-term strategy on the domestic and regional market as opposed to export markets if the current trends in EPZ textile production continue.

Foreign ownership of EPZ firms is another factor that affects domestic firms as well as the Kenyan economy. As mentioned earlier, foreign owned firms enjoy generous tax incentives as well as other benefits such as unlimited repatriation of profits. This means that foreign owned firms contribute less to the economy because a smaller percentage of foreign investors are likely to re-invest their profits in the domestic economy compared to domestically held firms. Foreign ownership of firms has declined in relation to domestic firms, but the majority of firms are still foreign owned. In 2009, 56.6% of firms were foreign owned, 19.3% of firms were wholly Kenyan owned, and 24.1% of firms were joint ventures between Kenyan and foreign investors (EPZA 2010).

In an effort to increase the number of domestic manufacturers in EPZs, the EPZA has recently launched a program called the EPZ Business Incubation Programme. The objective of this program is to nurture small Kenyan (minimum 75% Kenyan owned) export-oriented enterprises into medium and large enterprises within four years of being admitted to the program (EPZA 2008). In order to qualify for the program, domestic manufacturers must meet several requirements such as operating in target sectors of horticultural/food processing, commercial crafts, textiles and apparels, or information technology; demonstrate business knowledge and entrepreneurial expertise; operate in a sector with high growth potential; plan to have an 80% export oriented business within four years of locating in the business incubator; and employ a labour force of fewer than 100 (Ibid.). The incentives for firms taking part in this program include a 10 year corporate tax holiday; duty and value added tax exemptions on raw materials, machinery and other inputs; financing assistance; marketing assistance; and other business development support services (Ibid.). The first phase of this project is fully leased with two firms operational and 4 projects approved in total; currently construction is underway on the second phase of the project (Ibid.). However, the project is still in its infancy and it is difficult to determine if it will address the broader objectives of the EPZ such as increasing exports, long-term employment creation, and more technologically advanced manufacturing.

Despite efforts by the EPZA to increase linkages by implementing the Business Incubation Programme, recent developments suggest that tensions are increasing between EPZ firms and non-EPZ domestic firms. EPZ firms want to sell more of their product in

the domestic market, due to increasing competition on the international market, and domestic manufacturers believe that tax incentives given to EPZ firms constitute an unfair advantage. In 2009 the domestic market accounted for 9% of total sales by EPZ firms (EPZA 2010: 40). However, the EPZA wants to increase the share of domestic sales by EPZ firms to 70% of total sales and eliminate the 2.5% duty charged on goods sold by EPZ firms in the domestic market (Wahome 2010). Betty Maina, the chief executive officer of the Kenya Association of Manufacturers (KAM), the organization representing local manufacturers, stated that, “They [EPZ firms] enjoy tax holidays besides other tax exemptions, reduced import duty and waivers meant to promote exports. If these people are allowed to off-load their products in the same market we operate in, it would give them undue advantage” (as cited in Wahome 2010). According to the EPZA, foreign owned EPZ firms have threatened to relocate their operations, when their contract expires, if they are not given greater access to the local market (Ibid.).

Allowing EPZ firms to increase their domestic sales to 70% is a significant departure from the traditional EPZ model. The purpose of an EPZ is to manufacture for export not for domestic consumption. Pitting EPZ firms against local manufacturers for the domestic market could undermine the objective of developing strong linkages between EPZ and non-EPZ firms and furthermore it has the potential to drive local manufacturing firms out of business.

Overall this section has shown that linkages between EPZ firms and local manufacturing firms are weak because many of the inputs used in EPZ production are sourced from foreign producers. Although cotton production is set to increase in Kenya,

in an effort to supply EPZ textile firms, this increased production may not be used by EPZ firms if textile production continues to decline or if cheaper cotton can be secured abroad. Lastly, domestic manufacturers may be weakened by EPZ firms if they are forced to compete head to head for domestic market share, especially if the tax incentives and government subsidies enjoyed by EPZ firms are not extended to domestic manufacturers.

Employment in EPZs

The purpose of discussing employment in EPZs is to show the extent to which EPZs are meeting the government's objective of creating employment in manufacturing. From the inception of the EPZ program, the government has maintained that creating employment is one of the primary objectives of the program. In an effort to evaluate the effectiveness of this objective, this section of the data chapter consists of three components. The first component provides a brief overview of employment in Kenya with regard to labour by sector, employment growth in the formal and informal sector, and key issues in employment creation. The second component examines the performance of the EPZ program with regard to the number of jobs that have been created as well as the quality of these jobs in terms of wages and other qualitative factors. Finally, there is an overall evaluation of the employment creation strategy in the EPZ program.

The government of Kenya consistently lists employment creation as one of its key objectives in development planning. The PRSP for 2003-2007 listed job creation of 500,000 jobs annually as one of its central macroeconomic objectives (IMF 2005: 3).

However, rapid population growth in Kenya means that roughly 500,000 people join the labour force annually; the result is that the creation of new jobs is barely able to keep up with the growth in the labour force and the unemployment rate remains high (Manda 2004: 32). The majority of employment growth in Kenya is in the informal sector; the activities in this sector consist mainly of “manufacturing, building and construction, distributive trades, transport and communication, and community and personal services industries” (KNBS 2010: 78). In 1988 20% of employment, excluding small scale agriculture, was in the informal sector; in 1992 the informal sector accounted for 44.9% of employment; in 1996 it was 61.1%; and in 2000 it was 70.4% (Manda 2004: 25). In 2009, the informal sector accounted for nearly 80% of employment, employing 8.3 million people (KNBS 2010: 69). Within the informal sector, wholesale trade, retail trade, hotels, and restaurants accounted for the majority of employment, employing 4.9 million people (Ibid.: 79). Manufacturing was the second largest employer, employing nearly 1.8 million people (Ibid.). This type of manufacturing is generally made up of small enterprises engaged in furniture making, small engine repair, welding, sewing, and other small scale manufacturing.

The substantial growth in employment in the informal sector in comparison with the formal sector means that employment has become less secure, labour standards are more difficult to enforce, and the potential for union organization in the workplace has been eroded.

Employment in the formal manufacturing sector has remained stagnant since the 1970s and many domestic manufacturers are unable to compete with cheap imported

goods and have been forced to cease operations, shrink the labour force, or casualize employment to stay competitive (Ibid.: 12).

One of the central objectives of the EPZ program is to increase formal sector employment. In the early 2000s EPZs achieved substantial yearly increases in employment due to the growing number of textile firms locating in them. The growth in EPZ employment was a direct result of the AGOA agreement between the US and Kenya, as discussed in the previous section. However, after the expiration of the MFA in 2005, steady yearly declines in EPZ employment ensued due to increased competition from lower cost textile firms in Asian countries (See table 3.6). The number of garment manufacturing firms operating in the EPZ decreased from a high of 35 in 2003 to 19 in 2009 (table 3.5).

Table 3.6 EPZ Employment Statistics 2001-2009

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009
Local Employees	13,444	26,447	38,199	37,723	38,051	36,767	34,446	30,187	30,115
Expatriates	314	701	912	837	800	649	511	471	508
Total employment	13,758	27,148	39,111	38,560	38,851	37,416	34,957	30,658	30,623

Source: EPZA 2010

The textile sector continues to account for the majority of employment in EPZs, despite the decrease in the number of firms in this sector. Out of the 30,623 employees in the EPZs, nearly 80% worked in the textile sector in 2009 (EPZA 2010: 24). The proportion of EPZ employment in relation to overall manufacturing employment has also declined steadily since 2003. In 2003, EPZ employment accounted for nearly 16% of all manufacturing employment in Kenya and in 2009 it fell to 11.5% (Ibid.: 28). The

employment data suggests that the EPZ program is failing to create employment in other sectors to offset the loss of jobs in textiles.

Apart from the overall decline in employment, wage rates have failed to keep pace with inflation. The *EPZA 2009 Annual Report* states that average monthly wages have increased from Kshs 5,233 in 2003 to Kshs 9,059 in 2009, representing a 73.1% increase (Ibid.: 33). This wage is slightly higher than wages in the manufacturing sector as a whole which average about Kshs 8000 per month (KNBS 2010: 77). However, it should be noted that most jobs in Kenya's manufacturing sector are in the informal sector and generally pay less than the formal sector. The wage increase in the *EPZA 2009 Annual Report* also fails to take into account the average annual inflation rate in Kenya based on the Consumer Price Index (CPI)¹². According to the World Bank, Kenya's annual inflation rate from 2003-2009 was nearly 12% (World Bank 2011b). The report does not mention the inflation rate in any of its wage statistics, even though this is a factor that must be considered when comparing such data. Kenya's overall wage rate, after factoring in inflation, decreased by 10.2% in 2008 and decreased again by 4.2% in

¹² The Consumer Price Index shows the annual percentage change in the cost to an average consumer for purchasing a fixed basket of goods and services. In Kenya the basket of goods is made up of 12 categories assigned different values (the sum of all values equals 100) to reflect how much the average consumer spends on each category. For example, in 2011 food and non-alcoholic beverages were assigned the highest value (36.04); the second highest value is housing, water, electricity, gas, and other fuels (18.3); Transport (8.66); Clothing and footwear (7.43); Household furnishings, equipment, and maintenance (6.16); Miscellaneous (4.52); Restaurants and hotels (4.48); Communication (3.82); Education (3.14); Health (3.13); Recreation & Culture (2.25); and Alcohol, tobacco, and narcotics (2.06). Values in each category are generally reviewed yearly to reflect changes in average consumer trends (Kenya National Bureau of Statistics 2011).

2009 (KNBS 2010: 78). The following table shows the wage data from the report and also includes the annual inflation rate based on the CPI.

Table 3.7 EPZ Wages and Annual Inflation Rate: 2003-2009

Year	2003	2004	2005	2006	2007	2008	2009
Average monthly wage locals (Kshs)	5,233	7,198	6,608	7,279	7,734	8,404	9,059
Average monthly wage expatriates (Kshs)	25,407	33,545	31,638	50,014	50,516	60,982	62,970
Average monthly wage locals (US\$)	69	91	87	101	115	122	117
Average monthly wage expatriates (US\$)	335	423	419	694	751	881	814
Average annual exchange rate(Ksh/US\$)	75.9	79.3	75.6	72.1	67.3	69.2	77.4
Average Annual Inflation (%)	9.8	11.6	10.3	14.5	9.8	26.2	9.2

Source: EPZA 2009, pg. 33; World Bank 2011b

To put these numbers in perspective, table 3.4 compares the actual wage increase with the 2003 wage, if it were adjusted for yearly inflation, using inflation rates from table 3.7.

Table 3.8 shows that the actual wage increase has not kept pace with inflation, particularly after 2006. The 2003 wage, after adjusting for annual inflation, would be over Kshs 2000 per month higher than the 2009 wage.

Table 3.8 EPZ Monthly Wage Increase and 2003 Monthly Wage Adjusted for Annual Inflation

Year	2003	2004	2005	2006	2007	2008	2009
Average Monthly Local Wage (Kshs)	5,233	7,198	6,608	7,279	7,734	8,404	9,059
Wage Adjusted for Annual Inflation (Kshs)	5,233	5,840	6,441	7,375	8,098	10,220	11,160

Source: EPZA 2009, pg. 33; World Bank 2011b

The widening gap between the increase in inflation and the increase in wages for locals suggests that employees in the EPZs are less able to purchase goods and services because their wage increases are not keeping pace with average price increases for basic necessities.

The decrease in real wages also suggests that EPZ firms are failing to move into manufacturing higher in the production chain. Generally, more skill intensive and complex manufacturing processes result in higher wages due to the production of higher value products, but this has not been the case in Kenyan EPZs.

In addition to the decrease in overall employment and the gap between wage increases and annual inflation, the quality of employment in EPZs is another factor that needs to be taken into consideration when evaluating the objective of employment creation. The introduction to this section mentioned increasing casualization as one of the major trends in overall employment in Kenya and EPZs have experienced a similar trend. The growing use of casual labour in EPZs has negatively affected employees because fewer of them are working as full-time labourers and enjoying the benefits associated with it. The number of casual workers versus permanent full-time workers is not published by the EPZA. However, qualitative data collected, by the author, through interviews, informal conversations, and discussions with current and former EPZ workers as well as various officials confirms that there is growing use of casual employment in EPZs. Although the various sources agree that casual labour in EPZs exists, they differ in their reasoning about why this is happening. In an interview, conducted by the author with an EPZA communications officer in August 2010, the interviewee admitted that the

use of casual labour was an ongoing challenge in EPZ firms. The reason that many firms used casual labourers, according to the officer, was that textile firms had large fluctuations for orders at specific times of the year requiring significantly more labour than other times of the year (Ibid.). These order fluctuations meant that textile firms needed to employ casual labourers to meet higher seasonal production targets to meet increased demand in countries like the USA for peak shopping periods such as Christmas. When production orders declined, the textile firms laid off the casual labourers. However, EPZ workers provided a different explanation for the increase in casual labour.

A former EPZ worker and shop steward with the Tailors and Textiles Workers Union (TTWU), during an interview with the author in August 2010, stated that the use of casual labour was a tool used by management to keep employees from joining the TTWU. The former EPZ worker said that prior to unionization in 2003/2004 most employees in the factories were full-time and permanent; however, after unionization textile firms began hiring more casual labourers; labourers were hired for less than three months and then laid off because, after three months, workers would no longer be on probation and the textile firms had to recognize them as permanent employees. Textile firms are required to pay a higher wage and provide more benefits to workers with permanent full-time status as opposed to casual labourers, thereby increasing production costs. Other conversations with workers and former workers confirmed the same trend with regard to casual employment. One EPZ worker explained that many labourers move from firm to firm every three months because they are unable to attain full-time and

permanent employment. This trend was also found in focus group studies with EPZ workers conducted by LARC in the spring of 2010.

Another issue raised by workers and former workers in interviews and conversations was the use of production targets. These production targets were set by the firm and each worker was required to produce a certain amount of pieces per hour. Many workers felt that the production targets were unreasonably high because they were not able to meet their production targets in the time that they were allotted. The result was that many workers stayed overtime to meet their production targets but they were not paid overtime by the firm unless their targets had already been met. Workers suggested that this was another reason that firms preferred to use casual workers because it prevented workers from unionizing and taking grievances about overtime pay to the TTWU.

Although the perspectives on the use of casual employment differ, the fact that casual employment persists is problematic from a development perspective. Casual employment is less secure than full-time permanent employment and this hinders the ability of workers to save and invest. Furthermore, casual employees are less able to organize and collectively bargain for better wages and benefits.

Overall, the EPZ program has performed poorly in meeting its objective of creating employment. The number of employees in the sector is declining, wage rates have not kept pace with inflation, and growing use of casual employees is leading to insecure employment. These findings suggest that the implementation of neo-classical economic theory, in the case of Kenya's EPZ program, has failed to create the type of

employment that it predicted. The World Bank stated that EPZs represented the first rung on a ladder toward higher value manufacturing and higher wage employment (World Bank 1995: 62). The government of Kenya embraced this view by offering generous tax incentives to attract FDI in EPZs in the hope that it would stimulate investment in manufacturing and lead to substantial increases in formal employment; the World Bank fully supported this initiative by financing 80% of the costs of creating Kenya's largest publicly funded EPZ in Athi River (EPZA 2011). However, after over a decade of EPZ development, there has been little diversification away from low skill textile and apparel manufacturing. The employment benefits originally envisioned have failed to materialize.

The Future of EPZs

The EPZA and the Government of Kenya are aware of the failure to meet the objectives of the EPZ program. The *EPZA 2009 Annual Report* lists several challenges of the EPZ program. The challenges listed include, barriers to selling goods on the domestic market; the global economic recession; increased competition from Asian producers; expiry of third country fabric provision under AGOA¹³; high cost of electricity for manufacturers; high wages for employees compared to Asian producers; and delays in importing raw materials and exporting goods due to port delays (2010: 37-38). The EPZA makes 11 recommendations for addressing these challenges (Ibid.: 38-40):

1. Consistency in Policy.

¹³ The expiry of this provision requires all textile firms in the EPZ to source fabric from Kenya or the US by September 30, 2012 for all US bound textile products.

2. A reduction in electricity rates charged to EPZ firms through government subsidy.
3. Duty on EPZ sales to domestic market based on the value of imports for a product as opposed to the price of the finished product.
4. Elimination of Value Added Tax on oil purchased by distributors that is sold to EPZ firms.
5. Increase of domestic sales to 70% for EPZ firms and elimination of 2.5% duty on locally sold products.
6. Reduction of corporate tax to 15% after tax holiday and a reduction to 12.5% for those in rural areas.
7. Allow for exemption from payment of withholding tax on dividends and other payments made to residents in Kenya.
8. Fast track transformation of EPZs into Special Economic Zones.
9. Increase efficiency of port operations.
10. Encourage the government to provide stimulus to help EPZ firms address the challenges of the global economic recession.
11. Urge the government to lobby the US for permanent AGOA agreement as well as an Economic Partnership Agreement (EPA) with the European Union (EU).

All of the recommendations, apart from subsidizing electricity rates, fall within a neo-classical economic framework. The recommendations emphasize the need to reduce transaction costs for producers, lower taxes, and ease international trade, all of which are central components to market-led export oriented industrialization policies as discussed in Chapter 1. The recommendations, if implemented, may provide some relief for EPZ

firms by reducing their costs and making them more competitive with Asian manufacturers. However, the recommendations fail to address the fundamental long-term problems facing the manufacturing industry. There are several questions that remain unanswered. For example, will reducing taxes on EPZ firms mean that they will reinvest their profits in Kenya to make their operations more productive? Or will profits continue to be repatriated out of the country? Will allowing EPZ firms to sell more of their product on the domestic market strengthen all Kenyan manufacturers? Or will EPZ firms drive non-EPZ firms out of the market? Will trade agreements with the US and EU improve Kenya's balance of trade? Or will it allow more non-Kenyan manufactured goods to be imported cheaply at the expense of domestic manufacturers?

There is an implicit assumption by the EPZA, and by extension the Government of Kenya, that what is good for EPZ firms is necessarily good for Kenyan manufacturing as a whole. However, the EPZ program is detached from a comprehensive industrialization strategy that addresses the fundamental weaknesses of the Kenyan manufacturing sector; this is becoming apparent as tensions increase between KAM and the EPZA.

The recommendations from the EPZA seek to deepen processes of economic liberalization in the belief that previous economic liberalization has not gone far enough to foster a competitive manufacturing sector and attract foreign investment. The plan outlined for the manufacturing sector in Vision 2030 provides evidence of the ongoing commitment to economic liberalization.

Vision 2030 calls for the development of industrial and manufacturing zones in different parts of the country. The different activities in these zones would consist of meat processing/tannery operations, agro-processing, tea and coffee packaging for export, horticulture, and fish processing (Ministry of Planning and National Development 2007: 64). The government plans to fund the infrastructural development of these zones through investments in ports, roads, rail, and utilities. The government also plans to offer financial incentives to foreign firms investing in SEZs. Initially, “A pilot site [SEZ] will be set up in Mombasa to allow for easy importation of necessary raw materials and exporting of finished goods” (Ibid.: 64). In addition to the SEZs, the government also plans on developing five small and medium enterprise industrial parks in key urban centres by investing in infrastructure and services to make them attractive for investors (Ibid.: 64).

The overall plan for the manufacturing sector, as detailed in Vision 2030, consists of three strategies. The first strategy is to strengthen local production by defending local industries from counterfeit and dumped goods as well as increasing their productivity; the specific goal is to reduce imports in key local industries by 25% (Ibid.: 63). The second strategy is to expand the regional market by developing special economic clusters and improving regional collaboration; the specific goal is to increase regional market share from 7% to 15% (Ibid.: 63). The third strategy is to increase exports to the global market through development of SEZs and negotiating more trade agreements; the specific goal is to attract at least 10 large strategic investors in key agro-processing industries (Ibid.: 63).

The specific goals outlined in the plan for local, regional, and global industries, if met, would strengthen the manufacturing sector. However, the strategies for reaching these goals are similar to the strategies used in the EPZ program which has so far failed to have a significant impact on improving Kenya's overall manufacturing performance. For example, the government built infrastructure to support EPZ development, generous financial incentives were given to foreign firms, and Kenya secured a trade agreement with the US through AGOA, but the program failed to transform Kenya's manufacturing sector. It is unlikely that using the same strategy will produce vastly different results in Kenya's current economic development plan.

Conclusion

This chapter presented data on three different aspects of the EPZ program: the contribution of EPZ exports to overall exports; linkages between domestic firms and EPZ firms; and employment creation and the casualization of labour in EPZs.

The data showed that the contribution of EPZ exports to overall exports is declining, and EPZ firms have failed to significantly diversify into higher value added manufacturing; the majority of exports are made up of textile products. EPZ textile firms are also closing as they are less able to compete with cheaper Asian producers after the expiration of the MFA.

The data also showed that linkages between domestic firms and EPZ firms remain weak and local manufacturers face the threat of losing market share to EPZ firms if they

are allowed to sell more of their product on the domestic market at lower cost because of generous government tax incentives and other subsidies.

Finally, employment in EPZs is decreasing, wage rates have not kept pace with inflation, and the use of casual employment is widespread. The decline in real wages means that workers are less able to afford basic necessities as consumer prices increase and it also means that workers are contributing less to domestic demand for locally made products. The increased use of casual labour is preventing workers from unionizing and it also prevents them from securing full-time permanent employment with greater benefits.

The findings in the data suggest that EPZs have failed to meet their core objectives of increased and more diversified manufactured exports; increased linkages between domestic and EPZ firms; and more formal sector job creation.

Chapter 4

Conclusion

The purpose of this thesis was to determine the extent to which Kenyan EPZs were contributing to industrialization and development. It is a timely issue because countries throughout SSA and throughout the developing world are developing EPZs, or some variation of them, to stimulate their manufacturing sector.

The thesis statement argued that the Kenyan EPZ program would fail to achieve its stated objectives because it left little room for the state to take an active role in industrial policy and promote domestic capital. This was based on the findings in the literature review which suggested that EPZs were too detached from a national industrial strategy because it prioritized foreign capital over domestic capital and few restrictions or regulations were put in place on foreign capital to ensure that domestic development objectives were met.

The theoretical discussion in the literature review showed that mainstream development theory has embraced a neo-classical economics approach to industrialization which prioritizes market-led policies over state-led policies in the belief that they are more efficient and necessary for transforming the industrial sector in developing countries. However, many of the industrial successes in the NICs were due to state interventionist policies that protected and invested in domestic industries.

The discussion of Kenya's industrial policies showed that despite the success of state intervention in the industrial development of the NICs, Kenya abandoned many of its state-led industrialization policies in favour of liberalized markets and an emphasis on

lowering transaction costs in an effort to attract FDI. Many of the reforms in the industrial sector were a result of external pressure, in the form of threats to withhold financial aid, from IFIs and donor countries. The transition from state-led industrialization in Kenya to market-led industrialization approaches did little to stimulate the industrial sector and there was little growth in the sector in relation to the rest of the economy from the 1970s to the present.

The case study of EPZs showed that the EPZ program in Kenya has failed to transform the industrial sector and meet the objectives of the program as stated by the government. There has been little diversification into higher value production in EPZs; there have been few backward linkages with domestic firms; there has been little sustained increase in job creation, and the wages earned by local employees in the EPZs have failed to keep pace with inflation.

The data from the findings shows that the EPZ program is failing to meet its objectives and is not able to transform Kenya's industrial sector.

From a broader development perspective, the failure of the EPZ program suggests that a neo-classical economics approach to industrialization in developing countries is ineffective in meeting broader development objectives of becoming more economically self-sufficient by manufacturing a greater number of products locally whereby profits stay within the local economy and are able to be re-invested. Neoliberalism, has taken the place of colonialism by enforcing a system of trade in which Kenyan raw commodities (tea, coffee, cut flowers) or low level manufactures (textiles and apparel) can be shipped cheaply from Kenya. Conversely, barrier free trade allows more developed countries to

sell manufactured products on local markets at a price that prevents local manufacturers from developing and providing Kenyan made products to the domestic and regional markets. The data on exports and imports shows this trend becoming more pronounced as the trade deficit increases; the value of imported manufactured goods is growing far more quickly than the value of export commodities.

The failure of the EPZ program to meet its stated objectives should give policy makers a reason to rethink Kenya's economic development strategy with regard to industrialization. However, broader policy discussion, involving state intervention in the manufacturing sector, will likely meet resistance from the World Bank, the WTO, and donor countries. These external forces have placed tremendous pressure on the government of Kenya, by withholding financial support, in return for liberalized markets and privatization of state-owned enterprises in the 1990s, and they continue to pressure Kenya to continue liberalization reforms through trade agreements like AGOA and PRSPs (see Chapter 2). The current plan for the manufacturing sector, as outlined in the previous chapter, does not appear to significantly depart from the neo-classical economic theory underpinning the EPZ program. In Kenya's recent economic development plans there is still a firm commitment by the government to private investment in manufacturing and increased liberalization of the market; the government believes that its role should be limited to investing in key infrastructural products to ease the flow of goods to the market and providing a competitive environment for private investors through tax incentives and a stable and efficient regulatory regime. However, there is little consideration of a more active role of the state through tariffs, subsidies, state-

owned enterprises, or other forms of industry protection to stimulate the sector.

Considering the disappointing performance of Kenya's manufacturing sector to date, and continued reliance on raw commodities for exports, the policy discussion should be broadened to consider more active state intervention.

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