PRIVATE SECTOR DEVELOPMENT IN KENYA
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1.0 EXECUTIVE SUMMARY

The Kenya private sector has over the years substantially contributed to the country’s economic development process. Figures indicate that the sector contributes over 80% of the GDP, a substantial percentage of total employment, and the bulk of export earnings. The major growth sectors are Trade, restaurants and hotels; Agriculture, Manufacturing, Finance, insurance, real estate and business support services; and Transport, communications and storage. The sector has proofed its resilience despite various external and internal shocks that were experienced during the 1980s and 90s, and has also contributed significantly to diversification of export markets and range of export products. Such shocks include terrorism attacks in 1998 and 2001, which affected the tourism industry, import bans on fish in the 1990s and early 20s, trade wars which have affected tea exports, and various market entry constraints in the EU which have affected the horticulture industry. On the domestic scene, there are various challenges that continue to affect the investment climate for private sector activities, include uncompetitive infrastructure and utilities, unfriendly legal & regulatory framework for business operations, cumbersome trade facilitation and administration procedures, low levels of labor and capital productivity, a constraining macro economic business environment, high rates of crime, insecurity and poor governance, high levels of corruption, and an unfriendly environment for micro and small business operations. Measures to improve the investment climate include tight fiscal and monetary discipline, a comprehensive reform agenda on all production and operational environment, diversification of export markets for traditional products, a focused value programme, continued dialogue with countries and regional blocks that provide the major export markets, and a concerted effort to improve the operating climate for micro and small enterprises. These measures need to be urgently addressed so as to retain current investments and attract new investors, as a basis of facilitating the sector to drive the economy’s revival, a necessary condition for increased employment, reduction in poverty levels and increase in standards of living.

2.0 INTRODUCTION

Upon taking office in December 2002, the new NARC Government commenced on the process of preparing an Economic Recovery Strategy (ERS) for Wealth and Employment Creation 2003-2007, whose key focus is reviving the economy, creation of employment, and poverty alleviation, which were the platform upon which the government had been overwhelmingly voted into power. The emphasis on job creation and poverty alleviation was out of the recognition of the fact after experiencing moderately high economic growth rates during the 1960s and 70s, Kenya’s economic performance was far below its potential during the 1980s and 1990s, resulting into:

- Massive unemployment, which stood at over 2 million or 14.6% of the total labor force in 2002, with the youth accounting for 45% of the total,
- Rising levels of poverty in the country, with the number of people living in absolute poverty estimated to have risen from 11 million or 48% of total population in 1990 to 17 million or 56% in 2001. In effect the per capita income had declined from US$ 271 in 1999 to US$ 239 in 2002, thus lowering the standard of living for majority of the population.

From the early 1990s, Kenya had embarked on structural and macroeconomic reforms in all sectors of the economy, as a means of establishing the framework for an environment conducive to higher economic growth. However despite these reforms, Kenya’s economy performed poorly during the period 1990-2001 due to various factors, and managed to grew at minimal average of 2% between 1990- 1996 and 1.04% over the entire 1997-2001 period. Also during this period, the country suffered from declining levels of private investment, low savings and excessive government domestic borrowing. The country also witnessed a decline in the export/GDP ratio, from 32.1% between 1990 and 1995, to 27.5% between 1996 and 2000, and to further to 26% in 2001.
As part of turning around the economic decline, the NARC government rightly recognized that the private sector would provide the engine of driving the economy’s growth and development, so as to facilitate reduction of poverty levels, increased jobs creation, redistribution of growth outcomes to majority of Kenyans, and generation of sufficient resources to support the growth momentum both in the medium and the long term. Little however has not been done to put into place sufficient and specific interventions to spur the private sector activities since the ERS was issued, although the Government is currently spearheading the formulation of a Private Sector Development Strategy (PSDS), preceded by an action plan on quick fix reforms, which is being prepared in partnership with private sector stakeholders and development partners. Until a comprehensive reform programme on all business constraints is prepared and implemented, it will not be possible for the private sector to drive the economic revival agenda, while the sector also will find it impossible to contribute to achievement of the Millennium Development Goals, notably on poverty eradication and a substantial increase in standards of living by 2015. It is against this background that this paper has been prepared, whose objective is to provide sound information on the structure of the private sector in the country, the current bottlenecks hindering development and growth of the sector, and areas that require to be addressed through a comprehensive reform programme.

3.0 THE STRUCTURE OF KENYA’S PRIVATE SECTOR

3.1 Economic sectors

The structure of Kenya’s private sector is best understood from an analysis of the structure of the country’s major economic sectors and their contributions to GDP, employment and exports. Computations from the 2004 Economic Survey show that the country’s economy is categorized into four main four (4) main sectors, namely:

1. Non-monetary economy,
2. Monetary economy,
3. Government Services, and
4. Private households

The monetary economy takes largest share of the country’s GDP, and contributed at 83% of GDP in 2000 and 84% between 2001 and 2003. Since private sector activities take place under the monetary economy, this implies that the sector dominates the country’s economic activities. The monetary economy is comprised of twelve major sub-sectors that broadly represent the private sector activities undertaken in the country. In terms of their contributions to the monetary GDP, the five most important sub-sectors in order of priority are:

1. Trade, restaurants and hotels, which contributed 29% in year 2000, 30% in 2001, and 31% in both 2002 and 2003
2. Agriculture, which contributed 22% of the monetary GDP in 2000, 20% in 2002, 18% in 2002, and 17% in 2003
3. Manufacturing, which contributed 16% in 2000, 15% in both 2001 and 2002, and 16% in 2003
4. Finance, Insurance, real estate and business services, which contributed 12% in 2000, 11% in 2001, 10% in 2002 and 11% in 2003
5. Transport, storage and communications, which contributed 9% in both 2000 and 2001, and 10% in both 2002 and 2003.

Combined, these five sub-sectors took 87% of the Monetary Economy’s GDP in 2000, 85% in 2001, 84% in 2002, and 86% in 2003. In terms of employment, the country’s total formal employment grew from 1,695,300 employees in 2000 to 1,677,200 in 2001, 1,699,700 in 2002, and to 1,727,700 in 2003. The private sector contributed the bulk of this employment, at 1,002,800 or 59% in 2000, 1,018,700 or 61% in 2001, 1,040,900 or 61% in 2002 and 1,068,600 or 62% in 2003.
3.2 Highlights of the five major economic sectors

3.2.1 Agriculture sector

A summary of the range of products falling under the agriculture sector are:

1. Cereals sub-sector (e.g. maize, wheat, other cereals), takes up 1% of total agricultural marketed production,

2. Temporary industrial crops (e.g. sugar cane, pineapples, pyrethrum, horticulture, etc), take between 92-93% of the country’s total agricultural marketed production,

3. Permanent crops (e.g. coffee, tea, sisal), take up between 4-5% of the country’s total agricultural marketed production, and

4. Livestock and livestock products (cattle & calves, dairy produce, chicken & eggs), take up about 2% of the country’s agricultural marketed production.

The value of marketed agriculture production showed mixed growth trends during the period 2000 to 2003, declining from US$ 11,403.11 million in year 2000 to US$ 10,850.80 million in 2002, then picking up to US$ 14,003.80 million in 2002, before falling again to US$ 13,402.60 million in 2003.

Private sector activities contribute the bulk of employment within the formal agricultural and forestry businesses, and grew from 249,600 or 79.9% of total sector employment in 1999, to 252,300 or 80.5% in 2000, 254,700 or 81.5% in 2001, 256,300 or 85.7% in 2002 and 259,600 or 82% in 2003.

3.2.2 Trade, restaurants and hotels sector

The range of sub-sectors (trade, restaurants and hotels) falling under the sector are not properly broken down in Kenya’s statistical documents, in terms of their GDP contributions. The sector’s total GDP however recorded a positive and consistent growth trend during the period 2000 and 2003, growing from US$ 2,080.87 million in 2000, to US$ 2,465.43 million in 2001, US$ 2,910.03 million in 2002 and US$ 3,287.80 million in 2003. The businesses categorized under the sector include:

1. Trade activities: retail, wholesale domestic trade, and international trade (exports and imports)

2. Restaurants and hotel services

Regarding the trade sub-sector, clear data on the value of GDP for retail and wholesale trade is not properly recorded. On international trade, both exports and imports saw a steady increase during the period 2000 and 2003. Exports increased from US$ 1,534.65 million in 2000, to US$ 1,544.96 million in 2001, US$ 1,704.87 million in 2002 and to US$ 1,795.35 million in 2003. Major products exported during the period were: tea, horticulture, fish and fish products, un-roasted coffee, petroleum products, tobacco and tobacco products, animal and vegetable oils, soda ash, medicinal and pharmaceutical products, essential oils/ perfumes/ cleansing products, iron & steel/ metal items, and plastics articles. Regarding imports trade, the value of imports increased from US$ 3,175 million in 2000 to US$ 3,691 in 2001, declined to US$ 3,344 million in 2002, and then increased to US$ 3,702 million in 2003.

For the restaurants and hotels sub-sector, the key activities undertaken include hotel and restaurant services to local residents and non-residents. Earnings by hotels and restaurants from local residents are not well documented in Kenya’s statistical documents, but from non-residents, the data is well covered under the tourism sub-sector. This latter sub-sector has performed relatively well, despite negative publicity arising from terrorism attacks that took place in Nairobi (1998) and Mombasa (2001), and inter-tribal clashes that took place during the course of the 1990s.
Net inflows from the tourism sub-sector had reached an all time high of Ksh. 21,715 million in 1994, but declined to Ksh. 11,222 million in 1997 following the inter-tribal clashes of that year, and further to Ksh. 6,046 million in 1998 following the terrorist bomb attack of July in Nairobi. From 2000, the sub-sector has shown an impressive recovery, with net foreign exchange inflows increasing from US$ 147.81 million in 2000 to US$ 211.66 million in 2003. There was however a set back in the net foreign exchange inflows in 2002, caused by the Nov 2001 terrorism attack in Kikambala, Mombasa.

The sector employed a total 153,700 people in 1999, growing to 155,500 in 2000, 156,900 in 2001, 157,500 in 2002, and to 162,800 in 2003. The private sector contributed more than 95% of total labor employed in the sector during this four year period.

3.2.3 Manufacturing sector

This sector is quite diversified, and comprises of all products which in other terms are referred to as non-agricultural products, falling within chapters 25-97 of the Harmonized System. The major products falling under the sector are:

1. Textiles and clothing, which contributed 15% of the sector’s GDP in both 2000 and 2001. This contribution declined to 5% in 2002, and then rose to 11% in 2003.
2. Refined petroleum products, paints and varnishes, which contributed 13% in 2000, then declined to 10% in 2001 before rising significantly to 28% in 2002, and then declining again to 16% in 2003.
3. Transport machinery, where assembled motor vehicles constitute the bulk of products falling under this classification, whose share to the manufacturing GDP was 10% in both 2000 and 2001, rising to 11% in 2002, and then declining significantly to 3% in 2003.
4. Electrical machinery and alliances, whose contribution was 6% in 2000 and 8% in 2001 and to 9% in 2002, and then declining to 7% in 2003.
5. Metal products, which contributed 6% in 2000, 5% in 2001, rising to 9% in 2002 and further to 12% in 2003.
6. Paper and paperboard products, which contributed 6% in 2000, 7% in 2001, then declined to 4% in 2002 and to 3% in 2003.
7. Medicinal and pharmaceutical products, which contributed 4% in both 2000 and 2001, declined to 3% in 2002 and to 2% in 2003.
8. Organic and non-organic chemicals, pesticides and fertilizers, which contributed 5% in 2000, 6% in 2001, declined to 2% in 2002 and then rose to 4% in 2003.
10. Hides, skins and leather products, which contributed 6% in both 2000 and 2001, then declined to 3% in 2002 and to 2% in 2003.
12. Plastics articles, rubber products, cement, salt, wood and wood products, printing and publishing articles, non-electrical machinery and appliances, and glass products, which combined contributed 20% in 2000, 21% in 2001, 18% in 2002 and a significant 35% in 2003.

3.2.4 Finance, insurance, real estate and business services sector

The sector’s GDP increased from US$ 893.77 million in 2000 to US$ 943.69 million in 2001, declined to US$ 909.55 million in 2002, and then rose significantly to US$ 1,169.44 million in 2003. Total employment in the sector grew from 84,800 people in 1999 to 85,000 in 2000, declined to 83,800 in 2001 and further to 83,200 in 2001, before picking up slightly to 83,300 in 2003. The major reason for the decline in employment was the rationalization programme that the sector, went through over the 1990s, which especially was notable in the banking sub-sector as a result of the introduction of computerized banking. Private sector businesses contributed the bulk of employment in the sector, at an average of 80% for the four year period.

The finance sub-sector is well spread out, 43 licensed commercial banks in 2003, 4 licensed building societies, 3 licensed non-bank financial institutions, 52 licensed foreign exchange bureaus; and 2 licensed mortgage finance companies. Loans to private sector declined by 13.45% in 2003, while cash and deposits in banks more than doubled, which implies that the private sector was not taking credit either for new ventures, expansions or modernization, as a result of declining profitability caused by the depressed economy. The stock of non-performing loans decreased from Ksh. 77.3 billion in 2002 to 70.1 billion in 2003, which accounted or by 25.7% of total loans, compared to 30.2% in 2002, due mainly to a discount of the value of collateral considered unrealizable by the banks.

The insurance industry is also well spread out, with 42 registered insurance companies in 2003, 187 licensed insurance brokers, 1,507 registered insurance agencies and 217 firms undertaking other insurance intermediary activities. The notable developments in 2003 was introduction of joint insurance covers aimed at attracting and retaining foreign investments by the African Trade Insurance Agency (ATIA) in collaboration with the World Bank’s Multilateral Investment Guarantee Agency (MIGA). Data on the Business Services sub-sector is not documented in Kenya’s statistical documents, but such activities include Accounting, Engineering, Surveying, Architecture & Design, and Business Consultancy.

3.2.5 Transport, storage and communications sector

This sector is also quite diverse. The Transport sub-sector comprises of road, rail, air and maritime (shipping) transport. The roads transport sub-sector is further broken into passenger transport, freight transport, roads construction and rehabilitation (resealing and re-carpeting), with the latter activities now being undertaken by private sector under contract by either the central government or local governments. Air and rail transport includes passenger and freight/cargo. The rail transport handles about 30% of cargo cleared at the port for transport upcountry and to neighboring countries like Uganda, Rwanda, and Burundi. However, rail transport has experienced a continued decline both on passenger and freight transport in recent years, from 2.4 million tones in 1999/00 financial year to 2.33 million tones in 2000/01, 2.227 million tones in 2001/02 and further to 2.165 million tones in 2002/03. Passenger transport has suffered the same fate, with a decline from 5.517 million passengers in 2000/01, to 4,794 million passengers in 2001/02 and further to 4.4 million passengers in 2002/03. The country has one main private rail line operated by Magadi Soda Co. Ltd from Kajiado to its factory at Magadi, a distance of close to 900 Kms. Marine transport comprises of exported and imported cargo, handled at the Port of Mombasa, which combined, has steadily increased during the recent past, from 9.498 million tones in 1999 to 10.58 million tones in 2000, 12.717 million tones in 2001, 12.779 million tones in 2002 and to 14.384 million tones in 2003. The bulk of import and export trade is operated by the private sector. The Storage sub-sector comprises mainly of pipeline transport for refined petroleum products.
The Communications sub-sector comprises of postal services, telecommunications, electronic and print media. The Postal Corporation of Kenya (PCK) previously enjoyed a monopoly in provision of postal services, but the situation changed in 2002, when private operators were licensed, which enabled the number of postal correspondences to shoot up by about four times from 27 million in 2002 to 124 million in 2003. There have also been new developments in this sub-sector, after the entry of internet as an alternative means of sending and receiving correspondences. Regarding telecommunications, the sub-sector has experienced remarkable developments after the licensing of mobile telephone operations in 1999. The number of mobile telephone connections increased from 1.068 million in 2002 to 1.097 million in 2003.

Among the various sub-sectors, Communications has emerged as the most important in terms of value of output during the years 2000 to 2003, contributing 37% in 2000, 38% in 2001, 35% in 2002 and 27% in 2003. Roads transport follows as the second most important contributing 24% in 2000, 25% in 2001, 22% in 2002 and 23% in 2003. Air transport is becoming increasingly important, contributing 20% in 2000, 19% in 2001, 21% in 2002 and 24% in 2003. Maritime, storage/pipeline and rail transport, and services related to transport (for example licensing) take the balance of the sector’s GDP. The sector’s value of output steadily grew from US$ 1,210.98 million in 2000, to US$ 1,491.92 million in 2001, US$ 1,890.71 million in 2002 and to US$ 2,082.36 in 2003. The communications, roads transport and air transport demonstrated the most notable growth trends during the period 2000 and 2003. Total sector employment grew from 84,200 employees in 2000 to 84,300 in 2001, 85,500 in 2002, and to 86900 in 2003, with the private sector taking the larger share, growing from 53% in 2000, 55% in 2001, 56% in 2002 and 57% in 2003.

4.0 JUSTIFICATION FOR URGENT ACTIONS ON CONSTRAINTS TO PRIVATE SECTOR DEVELOPMENT

4.1 The private sector has made notable economic contributions over the years, as demonstrated by its contributions to GDP, employment and export earnings. These contributions need to be strengthened and safeguarded.

4.2 The sector has also proved its resilience to external shocks, which require strengthening. Overtime, the country has been able to build a strong private sector, which has in turn contributed significantly to the creation of a diversified economy, as evidenced by the broad range of private sector activities that take place under the monetary economy. For example, a strong and diversified regional financial center has developed over the years, enabling the banking sector to be well capitalized with an estimated average risk weighted capital adequacy ratio of 17.2%, well above the 12% minimum national requirement. Also, a strong stock market has evolved in the country, enabling Kenya to be rated as having the second largest stock market in Africa. The country has been able to build a large and strong manufacturing sector, which on average contributes 13% of the GDP, and which enabled the country to quickly turn around after the economic liberalization of early 1990, from reliance on the traditional EU market the regional COMESA market.

4.3 The sector is the home of the dynamic tourism sector, which is endowed with a unique combination of tourist attractions, comprising of tropical beaches, and abundant wildlife in their natural habitats, scenic beauty and a geographically diverse landscape. These attractions have enabled the sector to withstand external shocks like the aftermaths of the terrorism bomb attacks in July 1998 and November 2001 in Nairobi and Mombasa respectively. The sector currently accounts for about 10 percent of the Gross Domestic Product (GDP), making it the third largest contributor to GDP after agriculture and manufacturing, and Kenya’s third largest foreign exchange earner after tea and horticulture. It is also a major source of employment, estimated in 1998 at over 500,000 jobs.

4.4 The sector also hosts tea & horticulture, which have enable the country to make significant inroads in exports, and today Kenya is rated as the largest exporter of the two products in the African continent. The two products accounted for 47.06% of Kenya’s total exports in...
Also, Kenya has become a household name in exports of cut flowers, and the country today is the second largest world exporter of cut flowers after Holland, with roses taking the largest share of flower exports, and with Kenya currently supplying an average of 62% of all roses purchased in the EU. Horticulture has also become a significant employer in the country.

Apart from the economic contributions and the need to safeguard the growth sectors, there is also need to improve on the investment climate for the sector’s operations, which has been eroded over the years, especially during the 1980s and 90s, a result of which was a steady decline in the rate of private investment relative to the GDP, from 18% in 1996 to 12% in 2002, and further to 10% in 2003. This has also led to deterioration in investor perceptions of Kenya as a good investment location, reflected in the sharp decline in Foreign Direct Investment inflows during the last two decades, from $57 million in 1990 to $14 million in 1999; or about 30% of GDP in 1970s to less than 14% in 2002.

5.0 THE CURRENT SITUATION ON THE INVESTMENT CLIMATE

5.1 MACRO ECONOMIC CHALLENGES

5.1.1 Inflation: While the overall inflation rate had closed at 10% in 2003, there was a volatile trend over 2004, with an increase to 10.23% in January 2004, declining thereafter to the lowest rate during the year of 8% in July, then rising to close at 11.62% in December. Although some factors responsible for this volatility may have been beyond the economy’s control, such as increases in price of imported oil, there are many factors which could have been arrested, such as increases in salaries of teachers and members of parliament. There is need for a stable inflation rate as a factor that determines macroeconomic stability, and therefore which has an influence on the trend of private sector investment.

5.1.2 Interest rates: There was a steady decline in the overdraft lending rate from 14.13% in October 2003 to the lowest rate in 2004 of 10.72% in July 2004. Thereafter, the trend was unstable, with slight increases and decreases all the way up to December 2004, which closed with a 12.69%. On the 91 days treasury bills, the rate increased from the lowest rate of 1% in October 2003, to 8.04% in December 2004. Overall, there was instability in the average lending rate in the whole of 2004, which reflects badly on the level of macro economic stability, and which may have resulted into withholding of especially foreign investments. The positive note is that the level of bank credit to Government declined in 2004, though by a small margin of about 2%, compared to 2003, where bank credit to Government to finance its budget deficit had increased by 23.1%. The result of the slight decline in bank credit to Government led to a decline in the percentage of Government expenditure to GDP, from 25.96% in April 2004 to 24.86% in November 2004. This had a positive effect on level of bank credit to private sector, which increased by about 23.6% in 2004, with some of the growth sectors like manufacturing, transport, business support services, agriculture, real estate and trade taking s substantial share of funds available. It is important to have a stable interest rate, and therefore the need for the Government to keep a tight control on its level of borrowing from the banking sector.

5.1.3 Exchange rate: Overtime, the Kenya shilling has depreciated relative to international currencies, from 72.93 to the US$ in 19999 to about 78 to the dollar over 2004. However during the year 2004, the rate was unstable, hitting an 81 rate in December. It has thereafter come down, which shows its level of instability, and which therefore makes it quite unpredictable to investors. It is therefore necessary for the Government to maintain good relations with international lenders in order to arrest the instability of the shilling.

5.1.4 Wage rate: The key area of concern is the constant increases in wages and salaries that are not productivity driven. For example, real wages rose risen by about 250% in private sector and 228% in the public sector between 1999 and 2003, as a result of regular increases in the
minimum wages announced every year by the Minister for Labour, but not as a result of increased productivity in either of the sectors. There is need therefore to enact and implement an incentive-driven policy on wage increases aimed at spurring increases in labor productivity.

5.2 BOTTLENECKS ON QUALITY COST OF INFRASTRUCTURE AND PROVISION OF UTILITIES

5.2.1 Electricity: This is cited as among the top three most serious constraints to doing business in Kenya. A comparison of the electricity costs between Kenya and competitor countries shows that Kenya is quite uncompetitive on cost and provision of power. The problem is caused by the fact that electric power is hydro-based, thus exposing the country to power shortages in times of drought, as happened in the year 2000. The electricity provider, Kenya Power and Lighting Company, is also considered inefficient in power distribution. For example, power shortages arising out of inefficiencies and losses in transmission and distribution average 21% of total energy produced. Businesses in effect bear the effects of such inefficiencies, through uncompetitive cost of power, poor transmission and distribution, thereby making the country’s products more expensive than in competing countries. For example, in the textiles and clothing sector, electricity contributes a high of 67% to the cost of an export-oriented finished garment. Within the coffee cooperatives sub-sector, electricity accounts for close to 18% of operational costs during drying of coffee beans, while for coffee plantations, it accounts for an average 26.3% of operational costs. On average, electricity costs between US$ cents 0.10 to 0.15 per kWh in Kenya, compared to US$ cents 0.04 - 0.015 per kWh in South Africa, US$ cents 0.02 per kWh in Zambia, 0.023 in Malawi, US$ cents 0.025 per kWh in Egypt, 0.008 in China and 0.007 in Malaysia.

In addition to the high cost of electricity, provision of the utility is erratic, which results to loss of production time and consequently lower productivity of enterprises. In 2002, manufacturers in Kenya experienced an average of 33 power outages, which together with power surges, resulted in an average lost production value of 9.3% to total annual sales, in comparison to Uganda’s figure of 5% and China’s 2%. In addition, 64% of manufacturing firms experienced damage to their equipment, estimated at an average of Ksh. 1.15 million (US$ 14,918) or 3% of output per firm in 2002, on account of power fluctuations and frequent outages. Majority of firms have also been forced to invest in stand-by generators, which pushes up production costs. They also face delays in electricity connection (estimated at two months), which is approximately twice that in Uganda and three times that in Tanzania and China.

5.2.2 Roads and Rail transport services: About 72% of the manufacturing enterprises in Kenya rate roads and rail services as either poor, very poor or “not available at all,” while about 94.6% of all investors rate the quality of roads as poor, compared to 65.4% in Tanzania, 45% in Uganda and 15.8% in South Africa. The poor quality of roads directly diminishes a firm’s competitiveness and profitability, through delays in transportation, which is especially serious for perishable products and those that face tight export deadlines, for example horticulture. In 2002/03 for example, about 3.5% of export cargo was rejected as a direct result of delays in delivery to markets. About 24% of enterprises report that they have at one time or another spent resources in improving the quality of roads that lead to their production facilities. A small number of enterprises use the rail system in Kenya, because of its poor state of maintenance, and have instead turned to use of roads transport, which although more expensive than rail, is more efficient since the transport vehicles are either company owned or provided by private sector operators. However, although about 84% of enterprises use road transport, trucks maintenance absorb between 8-10% of overhead costs. It costs approximately US$ 0.722 to haul one kg of cargo from Nairobi to Mombasa by road.
and approximately US$ 0.019 per kg by rail for the same distance. Still, those that use the rail transport rate the facility as poor, due to unavailability of wagons.

5.2.3 Port services: The Kilindini port suffers from outdated equipment, poorly trained personnel and corruption. As a result, port services in Kenya are very uncompetitive, with the charge for unloading being about 6 times the charge in Felixtowe (UK) port, while costs related to corruption arising out of the inefficient port clearance system are also high, at an estimated 75% of any business dealings with port authorities, or an average of Ksh. 9,750 per bribe. Mombasa’s container productivity is also rated to be between 1/3 and ½ of the accepted international standards. About 6 days can be lost in clearances and paperwork process alone, which translates into lost production. The delays, inefficiency in port clearance and bribes end up pushing the overhead costs of local businesses in all sectors.

5.2.4 Air transport: Air transport is rated by businesses as much more efficient than roads, rail and marine transport, with only 13% of manufacturing firms rating the quality as a constraint to their business. The major reason for the improved service is the privatization of Kenya Airways in 1996, which has enabled the airline to become a leading African carrier. However, one major factor that still constrains horticultural exports is the lack of south-bound traffic, resulting into domination of air transport cargo industry by commercial chartered airlines. Most of such chartered aircrafts travel almost empty to African airports such as JKIA to pick especially EU bound horticultural produce. The underutilized south-bound cargo space has to be paid for by increased freight costs. Also, due to the high demand for such commercial aircraft, freight forwarders have been forced to charge more for available cargo space, or to reduce the frequency and volume of such flights. However, although Kenya’s freight rates are considered high by exporters, they are almost at par with regional competitors, but higher than some countries closer to Europe. For example the Kenyan cost is US$ 1.6 per kg to EU, while the cost is US$ 0.8 per kg between Israel and EU and US$ 0.9 per kg from Egypt to EU. Also, high cost of jet fuel in Nairobi contributes to high freight costs, estimated at US$ 1.08 per gallon, or about 20-40% higher than in Khartoum and Tripoli where some aircrafts land to refuel. The high landing and navigation costs of approximately US$ 3,054 per flight also contributes to the high freight costs, which is higher than in Dar es Salaam by about 30%.

5.2.5 Water and sewerage: Water and sewerage provision in Kenya is rated as either poor, very poor or not available at all, as a result of underinvestment in necessary infrastructure, poor management, illegal water connections, lack of billings, corruption during water treatment and payment of rates, and in some cases even complete destruction and abandonment of generation equipment. The problem is most serious in Nakuru and Mombasa. About 34% of Kenyan manufacturers and hotels have dug their own boreholes, a rate much higher than in Uganda (13%) and China (16%). Firms also have to bear the cost of extending lines from the main water distribution line to their factories, and pay for connection deposits of an average US$ 3,850 per firm, while the monthly water meter bill is also high at about 40 US$ cents, in comparison to Ghana where the cost is about 27 US $ cents. There have also been cases in Nairobi of untreated water being supplied to users, and cases where below the required chemical specifications are used in water treatment, which is a danger to human health.

5.2.6 Telecommunications: About 75% of manufacturing enterprises view telecommunications as a severe constraint to doing business in Kenya, while an average of 80% of all investors rate the utility as poor, compared to 26.6% in Tanzania, 31.8% in Uganda and 14.9% in South Africa. In Tanzanian and Uganda, telecommunications is actually placed last in the list of business constraints. Also, the cost of telephone calls is much higher in Kenya than in OECD countries. The cost in Kenya is US$ 0.9 cents for a one minute local call, US$ cents 40 for a long distance call and US$ 2.50 for an international call, compared to US$ cents 3-5 for a
local call, US$ cents 10 for a long distance call and US$ cents 10-30 for an international call in OECD countries. The telecommunications sector is also faced with long delays in obtaining a landline connection and in getting an in-operational line fixed. There are cases where applicants have waited for even up to ten years to get a fixed line connection after an application. These constraints suggest that there is urgent need for introducing private sector orientation in the sector, aimed at improving efficiency in telecommunications provision. In Uganda, there are two national landline telephone providers, while in Kenya there is only one inefficient monopoly provider - Telkom Ltd.

5.3 LEGAL AND REGULATORY ENVIRONMENT

5.3.1 Business registration and licensing: The current business registration is archaic, inefficient and unreliable, and imposes additional cost to investors in terms of money and time, and is especially a burden to SMEs. There are about 12 business registration procedures, in comparison to 7 in Ethiopia, 9 in South Africa, 6 in Zambia, 5 in Hong Kong and 6 in UK. These lengthy procedures result to delays in starting a business, whereby it takes an average of 47 days to start a business in Kenya, in comparison to 32 in Ethiopia, 38 in South Africa, 35 in Zambia, 18 in UK and 11 in Hong Kong. They also translate into costly operational costs, whereby Kenya’s cost of business registration is at an average 53.4% of business income per capita, compared to South Africa at 9.1%, Hong Kong at 3.4%, and UK at 0.9%. These costs increase when Environmental Impact Assessment requirements are included, and when lost management time, bribes and opportunity costs are accounted for. Other constraints related to starting a business include the cumbersome process of registering a business name, the process of company registration which is bureaucratic, lengthy and expensive, and the chaotic and unfriendly registration procedures at the Registrar’s office. Regarding business licensing, the Single Business Permit introduced in 1998 and implemented by local authorities is considered by businesses as a tax but not a license, since local authorities do not conduct any examination on health, safety and environment standards of a business premises prior to issuance of the license, but are merely interested in the revenue generated. The payment of the license is also duplicated among various local authorities, since even after paying for the license to the local authority in the area where production takes place, a manufacturer still has to pay similar licenses to all other local authorities where distribution of goods takes place.

5.3.2 The legislative framework for commercial activities: The current legislative framework governing insolvency and secured transactions in Kenya is outdated and not comparable to international best practices. The framework is characterized by:

- A rigid financial transactions framework, where some financial transactions, for example giving assistance for purchase of shares to small investors are not permitted in Kenya while they are allowed in other countries like UK, US, Canada, New Zealand, Australia and Hong Kong.
- Poor protection of the rights of minority shareholders in publicly quoted companies, especially if those that may wish to leave a company, for example due to change of the company’s ownership structure. The by-out of the minority shareholder by the company is not allowed in law while it has been allowed in other countries like England, Australia and New Zealand.
- Uncompetitive regime on time and cost involved in getting an insolvency case resolved, compared to neighboring and other competitor countries.
5.3.3 The legal framework for creating and enforcing secured transactions: Kenya’s legal framework for creating secured transactions is complex, technical and ineffective. It creates uncertainty and increases cost of transactions, and makes it difficult to create a credible system of enforcing credit collection. Current gaps in the legal framework include the lack of a comprehensive framework governing security of movable property, which explains why banks refuse to take moveable collateral such as stock as security for loans, and in most cases only accept land titles. This problem is further complicated by a multiplicity of land regimes, complexity of land laws and poor administration, and requirement for payment of stamp duty as a prior condition for any land transaction, which could delay the transaction for several months.

5.3.4 Commercial Dispute Resolution: Difficulties experienced in recovering credit through the court system are a major cause of restricted access to business credit in Kenya and its high cost. The causes of poor credit recovery include backlogs in hearing of court credit related cases, corruption in the courts, insufficient basic infrastructure like magistrates’ offices and court clerks, and the existence of only one commercial court in Kenya which currently has a backlog of an estimated 6,000 cases. Further, there are no other legally biding procedures apart from the court system for commercial dispute settlement. The result of the problems experienced in recovering credit makes Kenya quite uncompetitive compared to neighboring and other investor competitor countries on cost, number of days and procedures to enforce a contract.

5.3.5 Land use and transfers: Investors who have acquired land find it difficult to obtain site development approvals, connections to utilities and provision of services like roads. These difficulties are due to lack of a national land use plan and overlapping functions of Government authorities involved in land transactions. Except for EPZs, there are no written procedures, benchmarks, guidelines or formats that can be followed by investors when applying for approvals to site development or change of ownership. The decision on land use or transfer can take up to 12 months, but for those who wish to shorten the process, they have to hire expensive local consultants, or bribe officials of relevant authorities.

5.4 TRADE FACILITATION

5.4.1 Customs and Taxation Administrative Procedures: Manufacturing firms view customs and administrative procedures as major or very severe constraints to business operations. There are excessive delays in customs declarations and slow clearance procedures in all customs entry and exit stations. Customs is also accused by businessmen as being obsessed with maximizing revenue collections at the expense of its other objectives like trade facilitation, protection of society from trade in restricted or prohibited goods, and collection of trade statistics. The current delays arising out customs systems and procedures contribute to excessive delays in processing of imports, exports and transits cargo. The lack of an appropriate automated processing system results to customs procedures being predominantly manual, while documentation is excessive, compounded further by extremely high levels of physical verification of any incoming or outbound cargo. Little attention is paid on the compliance record of traders, while the relationship between customs and traders is characterized by mistrust on both sides. Ultimately, these weaknesses negatively affect the ability to export goods and import essential inputs for industry.

There is also no collaboration between Customs and other agencies involved in clearance of import and export cargo, such as the Kenya Bureau of Standards (KEBS) and the Kenya Plant Health Inspectorate Service (KEPHIS). KEBS carries out physical audit on samples of all imports, regardless of the results that may have been achieved on similar imports by the same importer. The KEPHIS procedure is currently a key challenge for horticultural exports,
due to the new EU requirement that horticultural exporters have to submit a copy of the phytosanitary certificate and EURO 1 form two hours before arrival of cargo by plane at the port of entry, while KEPHIS does not have the capacity to facilitate compliance to this new EU requirement.

5.4.2 Bottlenecks on administration of other taxes: The Kenya Revenue Authority is regarded by businessmen as obsessed with maximizing revenue collection, which is evident in the heavy reliance on financial auditing, punitive penalties, delays in refunding monies owed to taxpayers (particularly VAT refunds), and a perceived reluctance to issue rulings. These issues encourage rent-seeking practices especially among small-scale businessmen, and ultimately affect the efficiency and cost of doing business in Kenya.

5.4.3 Environmental bottlenecks: The National Environmental Management Authority (NEMA), at the beginning of 2005 issued a requirement that all industrial establishments have to carry out an Environmental Impact Assessment, including existing enterprises. It is questionable whether NEMA has the capacity to analyze all the submitted EIAs and issue the necessary approvals in time. Still, a question arises as to what would happen if the EIA was rejected for operational enterprises, because according to the Environment Act of 1999, an operational license can only be issued after the EIA is approved. A rejection of the EIA would mean appealing against the NEMA decision through the NEMA Tribunal, and if the Tribunal upholds the rejection, one can only appeal for reversal through the high court, which is already clogged with appeal cases. This could mean that a once profitable enterprise is rendered in-operational by EIA requirements. Also, the cost of consultancy on EIA is an additional cost to enterprises since it is not tax deductible. The requirement is also another legislative burden since not all enterprises are a threat to the environment, and it should therefore have been introduced for selected sectors only, not for all across the board. The legislation therefore needs to be revised, aimed at making it more business friendly.

5.4.4 Taxation levels and multiplicity of taxes: Enterprises feel that the level of corporation tax at 30% for resident companies and 37.5% for branches of non-resident companies is too high. It makes the cost of doing business in Kenya uncompetitive and discourages entry of new foreign investments. There is also concern that the number of business related taxes are too many, which include corporation tax, stamp duty, NSSF and NHIF contributions, motor vehicle advance taxes, fuel levy, standards levy and single business permit fees. These need to be harmonized with a view to reducing the tax burden.

5.5. AVAILABILITY AND QUALITY OF RAW MATERIALS

There are many manufacturing sub-sectors which face problems of insufficient availability and quality of raw materials, examples of which include:

5.5.1 Tanneries and manufacturers of leather goods: The bulk of hides and skins available from domestic slaughterhouses are exported, estimated at 8.7% of total. Also the quality of raw materials is rated as poor, due to poor animal husbandry and slaughtering practices and poor preservation after slaughter. Currently there are no standards on slaughtering practices, while grading schemes on hides and skins are also lacking. Various defects thereby occur before and after slaughter, and during preservation, resulting into a low level of premium grades 1 and 2. Also, the poor animal husbandry practices have resulted into shorter sizes of hides and skins. Investors cannot therefore be assured of sufficient quality of raw materials while collection of hides and skins is currently is disorganized and dominated by middlemen, who have complete autonomy on whether to sell their collections to local tanneries or to export.
5.5.2 **Wood and wood products:** After the 1999 introduction of the ban on logging, unlicensed ferrying and export of timber, unavailability of raw materials for the sector has been on the increase. As a result, recorded sale of timber decreased from 197.2 thousand cubic meters in 2001 to 162.0 thousand cubic meters in 2002, while the sale of power and telephone poles decreased from 4,900 cubic meters in 1998 to an absolute 0 in 2002. Various industries like sawmilling and wood products sub-sector have suffered as a result, including giant companies like EATEC Ltd which closed down in 2000. The unavailability of timber for sawmills and the consequent insufficiency of raw materials for upstream manufacturers of wood based products has also resulted into increased cost of raw materials for the sector. Closely connected to unavailability of raw materials is the low quality of timber, since local as well as imported timber is sometimes not well dried, graded, or is harvested too early, which affects the quality of locally made furniture.

5.5.3 **Textiles and clothing sector:** This sector suffers from insufficient availability of cotton lint, since out of the available 360,000 hectares suitable for cotton growing, only 40,000 hectares is currently utilized. The industry requires an estimated 120,000 bales of cotton lint per annum, but only 20,000 bales is currently being sourced from the domestic market, meaning that about 83% of the raw material has to be imported, especially from Tanzania and Uganda. The unavailability of cotton lint has resulted into escalating prices, which has increased to about US$ 1.5 per kg, while the world competitive price averages US$ 0.9 per kg. The quality of cotton lint is also bw, since Kenya’s variety is classified as of medium staple length, compared to Uganda’s variety which is considered of exceptional quality in terms of fibre length, color and fibre fitness. Other raw materials used in the sector like viscose, polyester, nylon, and acrylic fibres and fabrics are all imported, while garments manufacture depends entirely on imported fabrics, since a competitive integrated textile mill has not been locally developed.

5.6 **TECHNOLOGY**

A number of sectors use outdated technology in their production, examples of which include:

5.6.1 **Tanneries and leather goods sector;** where majority of tanneries operate with second-hand equipment imported from Europe, and which is about 20 years old. The equipment has high maintenance costs due to old age and lack of after sales technical service. Also, most tanneries have installed technology that is only capable for processing hides and skins up to wet blue stage, while only a few have installed technology capable of processing crust and finished leather.

5.6.2 **Wood based products sector;** which mostly uses labor-intensive methods of production, especially in small-scale sawmills and furniture making. Such labor intensive methods are used in logging and loading of timber. Majority of small-scale sawmills also have old and inefficient machinery, where tractor engines, electric motors and saws are used. Sun drying of timber is also quite common, which could take up to one year for some tree species to dry. There is poor technology in cutting of timber (*thick saw blades and poor cutting practices*), poor and sometimes complete lack of timber treatment, and employment of unskilled labor, which results into low recovery rate of between 18% and 30%. There is lack of use of quality standards in the sectors, resulting into such standards and inspection methods being specified by the customer, furniture producer or saw miller, while in most cases, firms use the “*experienced eye*” to pass products for sale into the market. Within plywood mills, the cutting technology currently used can only take logs of a certain minimum size, while in countries that have established successful wood based industries like Malaysia, the technology used enables the equipment to take a wide range of log sizes.
5.7 EXPORT MARKETS

This is an area that overtime has been dominated by traditional products like tea, coffee and of late horticulture, which are exported in raw form with minimal or no value addition. From mid 1990s however, some efforts have been made to export value added products, notably manufactured goods to COMESA region. The traditional products however require more value addition, aimed at increasing their export earnings and the benefits that accrue especially to small-scale farmers. Also, some traditional products like tea have over-concentrated in traditional markets, notably UK, Pakistan and Egypt. This makes them vulnerable to any slight price variations in such markets. The over-concentration also has sometimes made it difficult for the country to respect and adhere to its commitments under regional agreements like COMESA and EAC, for example the recent market entry problems in experienced in Pakistan that was a retaliation of Kenya’s enforcement of the agreed EAC tariff on imported rice. Fish products have suffered the same fate in EU, as a result of import bans especially during the 1990s on allegations that fish originating from East Africa had cholera and that there had been use of chemical fishing practices in the three countries, which directly led to a significant decline in foreign exchange earned on fish products to EU. Horticultural exporters have also experienced problems of market access in EU due to use of very strict rules of origin, introduction of market entry regulations without prior consultations, use of high product standards, and high tariffs on value added products. The rules EU of origin have also discouraged exports of manufactured products to the region since they only allow ACP originating products to enjoy preferential tariffs if the materials used are sourced from within the ACP, EU and overseas countries and territories aligned to EU. Regarding product standards, the WTO agreement on Technical Barriers to Trade allows member countries to develop and use higher than those already developed by international standards organizations, thus allowing the EU to develop very high standards, which in the end have become barriers to entry of ACP originating products. In many cases, ACP originating products may not even be anywhere near the international standards norms. With regard to introduction of market entry requirements that result into being entry barriers, the EU Minimum Residue Levels have restricted entry of ACP horticulture, which is quite difficult to adhere to in tropical countries such as Kenya which have to use pesticides so as to minimize multiplication of pests and crop diseases; yet a slight overuse leads to rejection of a whole export consignment. The newly introduced EUREGAP requirements is another major challenge for especially small scale farmers in ACP countries and particularly in Kenya, since the certification cost for good agricultural practices is beyond the reach of such producers, while they cannot also afford the subsequent cost of enforcing the certified agricultural practices, a requirement that may in future seriously affect the entry of edible products into the EU supermarkets chain that have introduced the requirement.

Regarding regional trade, the newly signed EA Customs Union presents challenges to local businesses, due the danger that it could result into diversion of goods imported from outside EA by both Tanzania and Uganda into the Kenyan market, on the pretext that they have been manufactured or produced in either of the two EA countries and that such imports should therefore attract zero tariff rates. Under the COMESA Free Trade Area, such diversion has already taken place, with some goods imported from outside the nine FTA countries being smuggled into the Kenyan market using zero rates of duty. A case in point is imported shoes, which the Eastern and Southern Africa Leather Association (ESALIA), has alleged are diverted through Malawi into the Kenyan market using the FTA duty rates, due to laxity in enforcing the rules of origin. There has to be strict enforcement of the EA and COMESA rules of origin to safeguard against such trade diversion.

Under the ongoing negotiations on a new EU-ACP Economic Partnership Agreement (Cotonou, formerly Lome Convention), the proposed reciprocal market access arrangements that are set to be enforced from the beginning of 2008 present new challenges to Kenyan manufacturers and farmers.
The Partnership Agreement could end up destroying Kenya’s manufacturing and agricultural base if a protected list of finished goods is not agreed upon during the ongoing negotiations.

For market entry to the US market under AGOA, the current concern is that the WTO MultiFibre Agreement expired at the beginning of 2005, after which textiles and clothing can now trade in the international market without the benefit of the previous quota system. Major garment manufacturing countries like China will now find it easier to penetrate international garment markets like the US, where Kenya has had a competitive edge due to application of the quota system. The end of the quota era could also mean that some garment industries relocate from Kenya to more competitive countries, as is already happening for Lesotho. Kenya’s continued advantage will only be on preferential tariff arrangements under AGOA. However, this advantage will be eroded by the fact that the bulk of fabrics used in EPZ and MUB enterprises are imported from third countries, which after 2007 will not be allowed. The end of 2007 is only two years away, which means that a domestic fabrics manufacturing base has to be developed urgently, part of which requires revival of the local cotton growing industry.

5.8 LABOR AND CAPITAL PRODUCTIVITY

The cost and productivity of labor in Kenya has been sighted as uncompetitive compared to major competitor countries like China, India and other newly industrializing countries of South East Asia. Kenyan labor costs on average US$ 0.36 per hour, in comparison to China at US$ 0.32, India at US$ 0.27, and an average of US$ 0.21 - 0.27 in Indonesia, Thailand and Malaysia. The unit cost of labor in Kenya is also much higher compared to Asian countries in the 1960s and 70s when they were at similar stages of development. At the same time, real wages in Kenya have risen steadily between 1999 and 2003, by about 250% in private sector and 228% in the public sector, without corresponding improvements in productivity improvements, resulting into Kenyan enterprises becoming less competitive compared to South East Asia countries during the same period. For example, in garment manufacturing, the average production in Kenya is 20-25 T-shirts per day, while in China, the production by the total of 45,000 garment manufacturers is 310 garments per second. Further, value added per employee in Kenya for most non-agricultural industries is quite low at an average of 5.9%, compared to competitor countries like China at 33.7% and Mauritius at 7.4%. Part of the contribution to low value added is the low level of skills development in the Kenya due to lack of training facilities, and use of old and inefficient capital equipment. Use of modern technology and appropriate training would benefit especially the informal, small and medium-scale enterprises in shoe design and styling to suite changing consumer demands.

5.9 COST AND ACCESS TO TRADE AND INVESTMENT FINANCE

While the cost of finance has dramatically come down over the last ten years from as high as 90% in mid 1990s to 16% in 2002/03 and to the current 5-20%, access is still a problem especially for small and medium scale enterprises due to collateral requirements, which is a hindrance to their development and growth since they do not have collateral to offer as security for credit. In Kenya, the value of collateral is estimated at 178% of the value of the loan, compared to 116% in Uganda and 87% in China. The high value of collateral is required by banks due to the lack of information on firms’ credit ratings, and due to the poor legal and institutional framework for credit collection and poor enforcement of loan contracts. The latter problem is partly as a result of borrowers stalling the process through court injunctions in about three quarters of the enforcement cases. The lack of a public credit rating institution and public registry in the country further compounds the problem, since banks are unable to share information on borrowers’ creditworthiness and also do not have a

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1 Value Added per employee refers to the difference between the ex-factor cost of the finished product, and the c.i.f. value of imported materials used in production, divided by number of employees in an enterprise.
cheaper mechanism to facilitate checking of which properties may have been charged prior to approving a credit, resulting to evaluation of a borrower’s credibility by the bank itself, which makes the operation expensive and pushes up the interest premium. The consequence is limited access by firms to working capital, and further, inability to invest in modern equipment, a problem that is more serious for small and medium enterprises. This has been the main reason why many firms continue to use old equipment, which is expensive to maintain and whose productivity is low. Apart from problems experienced in accessing credit, the level of non-performing loans in Kenya is high at about 28% of the total loan portfolio, further explaining why banks resort to high interest rates. This also encourages them to only approve loans for the largest and best connected borrowers. These constraints result to credit rejections for small enterprises and unknown borrowers, and also to high levels of loan default. Several countries that have established private credit bureaus and public registries have achieved a higher rate of information sharing (e.g. on assets, loans outstanding, payment behavior, accounts in good standing, defaults, arrears, data on individuals and firms, income per capita, etc), while many have gone further to establish systems for sharing such information online, thus enabling creditors to reduce risks and increase the rate of lending.

5.10 CROSS-CUTTING ISSUES

5.10.1 Institutional weaknesses

Most institutions that support private sector activities are either weak or under-funded. For those that are membership based, for example Kenya Association of Manufacturers, Kenya National Chamber of Commerce and Industry, Fresh Produce and Exporters Association of Kenya, Kenya Flower Council, Fish Producers and Exporters Association of Kenya, and the Kenya Private Sector Alliance, they don’t have internal capacity to analyse private sector constraints and impacts to business, and also lack internal capacity to offer business development services. This situation is made worse by the fact that for institutions funded under the public budget which could have filled the gaps, they are under-funded and therefore unable to fully discharge their mandates. On the other hand, such public institutions in many cases handle almost similar activities without complementing each others efforts. Such institutions include Export Promotion Council, Export Processing Zones Authority and Investment Promotion Authority, regarding attracting export oriented investments. There is therefore a need to have a national strategy on investment and export promotion, which is centrally coordinated, so as to maximize the meager resources available to the country.

5.10.2 Security, crime and governance: Security, crime and poor governance are costly to businesses and have contributed substantially to erosion of Kenya’s image as a good investment location. Poor governance has become a business concern since the lack of systems to facilitate accountability of government officers means that laws relevant to business are not enforced transparently, for example on smuggling and importation and trade in counterfeit products. Rising crime and deteriorating security have also increasingly become a business concern, and are linked to a weak police and judicial system. Official statistics show that crime in Kenya rose by 51% between 1994 and 2000, and that this figure may be higher, since police officers themselves are involved in crime which is never reported, while some criminal activities are never reported due to a growing sense of public apathy on the ability and will of the police to eradicate crime. About 34% of manufacturing businesses experienced at least one incident of theft or arson in 2003, while about 70% of firms identify crime and theft as a “major” or “severe” constraint to doing business in Kenya. About 56% of firm owners or managers view the police services as either “poor” or “very poor”, while out of all incidents reported to the police, only about 20% are ever
solved. In recent times, the press has constantly reported cases of businessmen being murdered, and of policemen being members of gangs that have committed major crimes. This has put a scare amongst existing and potential investors. Crime is also extremely costly to businesses, especially economic crime - fraud, embezzlement, extortion, money laundering, breach of trust and corruption, and accounts for an average 4% of sales revenue for 1/3 of manufacturing firms, who have also been forced to incur additional investment costs to protect themselves as a result of dissatisfaction with public security services. About 82% of firms have invested in private security measures such as fences, alarms and vehicles. These firms spend an average of Ksh. 100,000 (US$ 1,300) per month on security, or 2.7% of their sales revenue.

5.10.3 Corruption: This has increasingly become a major impediment to attracting investments in Kenya, and also impacts negatively on ability to carry out efficient business. The business sector has been significantly affected by the vice over the years, because any money spent to bribe various officials has somehow to be recovered, and normally is reflected in production costs, thereby making final goods uncompetitive vis-à-vis those from competing countries. About 73% of firms report that corruption is a major barrier to efficient business operations in Kenya, while bribes amount to 3.8% of annual sales turnover in manufacturing, compared to Uganda at 2.4% and China at 1.8%. Kenya was ranked number 96 out of 102 countries surveyed by Transparency International in 2002 in terms of degree of cleanliness. The country's score was 1.9, while major competitor countries achieved a much higher score, with South Africa at 4.8, South Korea at 4.5, Ghana at 3.9, and India at 2.7.

5.10.4 HIV/ AIDS: This has become a business concern due to its impact to operational costs as a result of declining productivity of infected workers, rising cases of sick-offs for salaried workers, business expenses to hospitalization bills and contributions to funeral expenses. The anti-AIDS campaign needs to be stepped up, while the need for encouraging people to own up to the disease needs to be increased.

5.11 SPECIAL PROBLEMS EXPERIENCED BY MICRO AND SMALL ENTERPRISES

MSEs experience other special problems in addition to those faced by other enterprises enumerated above. The special problems faced by MSEs include:

5.11.1 Inhibitive legal and regulatory environments: The centralization of registration of business names in Nairobi means many MSEs continue to operate without registration, while the requirement to give details of the business' physical and postal address is a problem for those without a permanent physical location, arising out of the fact that they don’t have a permanent land to operate from.

5.11.2 Limited access to markets: The market for MSE products is limited due to overproduction, over-concentration in one business area, insufficient access to local and export market information due to lack of investment resources to enter into electronic commerce, and high unit transaction costs due to low economies of scale. Also limited access to acquire, interpret and utilize information for example on legal and regulatory requirements hinders development of the sector.

5.11.3 Limited access to skills and technology: Many MSEs lack the institutional capacity to identify, seek and absorb modern technological skills, while the operating environment does not have mechanisms of encouraging coordination and transfer of appropriate technology.

5.11.4 Unfavorable taxation regime: The tax regime does not encourage MSEs to register and graduate into the formal sector. The administration and compliance costs are considered

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\[The\ higher\ the\ score,\ the\ higher\ the\ degree\ of\ \text{“cleanliness\ perception\ by\ business\ people,\ academia\ and\ country\ analysts”}\]
high and end up discouraging MSEs for example to register for VAT, since this would increase transaction costs.

5.11.5 Entry barriers: There are many self-styled regulatory cartels, for example within the matatu industry, which inhibit entry into the sector, and which push up the operating costs for existing businesses, due to payment of unofficial fees, sometimes on a daily basis.

6.0 RECOMMENDATIONS AND THE WAY FORWARD

6.1 Macro economic environment
- To facilitate movement towards a stable inflation rate in the country, the Government needs to keep tight control of future increases in wages and salaries.
- In order to facilitate development towards a stable interest rate and to ensure that the private sector is not denied of necessary funds for expansion, modernization and for daily operations, the Government should keep a tight control on its level of borrowing from the banking sector.
- To facilitate movement towards a stable exchange rate, the Government should maintain good relations with international lenders.
- An incentive-driven policy should be enacted aimed at spurring increases in labour productivity.

6.2 Infrastructure and utilities
- A master plan on electricity generation and distribution should be prepared. The plan should explore possibilities of connecting Kenya to the Southern Africa power pool and increased geothermal power generation and related costs. The aim should be to reduce electricity costs and increase efficiency in provision to levels that have been achieved in competitor countries - South Africa, Zambia, China, and Malaysia.
- Plans to license the second landline telephones company should be finalized without further delay, with an aim of introducing competition, so as to reduce costs and increase efficiency in telecommunications.
- The planned concessioning of the Kenya and Uganda Railways should be speeded up, so as to increase efficiency in rail transport, while providing an efficient and cost effective alternative to roads transport. The possibility of contracting out selected roads maintenance to contractors on a continuous basis should urgently be explored, to ensure that rehabilitation is not done only after complete breakdown. The possibility of facilitating the private sector to participate in rehabilitation of roads that lead to their enterprises and deduct related costs from tax payable through should also be considered. This would require a prior agreement to be signed between the Government and the industries in question.
- Specific measures regarding the necessary investments on water generation and distribution should be explored by the National Water Corporation, aimed at efficient water distribution and treatment.
- The cost of jet fuel needs to be reduced, aimed at especially benefiting the horticulture industry.
- The ongoing improvements in customs cargo clearance should be harmonized with activities of other bodies involved at exit and entry points, including those of KEBS, KEPHIS and Kenya Ports Authority, so as to have maximum impact in reduction of time taken to clear imports and exports.

6.3 Legal and regulatory environment
- The ongoing preparation of an “Investment Climate Action Plan” needs the support of the highest levels of Government, so that actions identified for reform can be implemented without delay.
Other recommendations include:
- Decentralizing business names registration from Nairobi to Provincial HQs so as to reduce time and cost especially for micro and small enterprises
- Eliminating the SBP which is currently a local authority’ tax, and allocating the necessary financial needs of local authorities from the national budget.
- Reforming the law on purchase and selling of stocks, to allow for a more efficient method of the buy-out of minority shareholders who may wish to leave a company for various reasons.
- Speeding up the process of declaring companies insolvent, to enable affected parties to start afresh.
- Establishing a committee of financial experts to work out modalities that would facilitate the process of moveable property such as stocks being accepted as security by banks.
- Reforms aimed at enabling commercial disputes to be settled outside the courts system.
- Reforming the process of sites development and transfer of land, so as to remove the excessive powers currently bestowed on councils.

6.4 Trade facilitation
- Revise the EIA regulations with a view to having only enterprises that have a substantial impact on the environment to have an EIA approved. Also, the cost element should be made tax deductible.
- The level of corporation tax needs to be brought down aimed at reducing the cost of doing business in Kenya.
- The current multiplicity of taxes needs to be harmonized.
- The ongoing customs modernization programme needs to be expanded to incorporate regular discussions between tax authorities and businesses, aimed at reducing mutual suspicions.

6.5 Raw materials and technology
A pilot project aimed at increasing the availability of raw materials and their quality needs to be established. Such a project needs to be started for selected industries that are local raw materials based, for example hides, skins and leather, textiles and clothing, and wood based industries sectors. The gains made should then be replicated to other sectors.

6.6 Exports marketing
- Measures to expand and retain export markets should be explored, including diversification of traditional markets and adding value to Kenya’s traditional products. In this respect, calculated and focused efforts should be made to explore emerging markets for value added products, including Middle East and Asia for packed horticulture, America and Asia for processed Coffee, and North Africa and South America for iced and packed tea. The Government should in this respect spearhead a programme of value addition and market diversification, aimed sustaining foreign exchange earnings from traditional products and increasing the unit earnings from such products.
- Small-scale farmers need to be educated on application of crop chemicals so as to meet the requirements of the minimum residue levels applied especially in EU, while at the same time, a national programme aimed at enabling them to meet the new EUREGAP requirements should be launched.
- Kenya needs to conclude on a protective list of manufactured and agricultural products to be used as the basis of discussing reciprocal trade arrangements with EU.
• The cotton industry should urgently be revived, as the basis of developing a sustainable fabrics manufacturing base before 2007, to enable the garments industry to retain and increase its US market.

6.7 Labor and capital productivity improvements
A national programme aimed at facilitating private sector participation in raising the level of labour productivity needs be established. A model could be started with one of the private sector associations operating the Athi River based Garments Training Center under a management contract, the success of which could latter be replicated for other sectors.

6.8 Access to trade and investment finance
More credit rating bureaus and a public registry needs to be established in the country. The credit rating bureaus would facilitate sharing of information between creditors of the credit worthiness of potential borrowers, while a public registry would give information to lenders on status of property being offered as loan security (e.g. whether charged or not). This would reduce the level of credit risk and encourage banks to increase their level of lending especially to small investors.

6.9 Cross-cutting issues
• A system aimed at facilitating the private sector to offer information to KACA and the police in confidence needs to be established. Also, a system aimed at raising the level of accountability of public officers needs to be started, to eliminate malpractices such as importation and trading in counterfeits, smuggling, selling of drugs, etc.
• The fight on corruption needs a clear direction, especially on prosecutions of high ranking public officials
• The anti-AIDS campaign needs to be stepped up, while the need for encouraging people to own up to the disease needs to be increased. Also the costs incurred by businesses on HIV related cases need to be treated like other operational expenses so as to encourage the private sector to participate more in the campaign.

6.10 Micro and small enterprises
The measures enumerated in Sessional Paper No. 3 of 2004 on “Development of Micro and Small Enterprises” need to be implemented without delay. In this respect, a roadmap regarding implementation needs to be prepared urgently.

References
1. Competitiveness in Kenya - June04; Regional Program on Enterprise Development (RPED) - Nov 04 (which covered 368 manufacturing enterprises in various sectors across the country); both World Bank
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6. Useful websites
7. UNIDO Yearbook of Industrial Statistics - 2002
8. Doing Business 2005; World Bank
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