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AFRICA PRIVATE SECTOR GROUP

INVESTMENT CLIMATE ASSESSMENT

ENHANCING THE COMPETITIVENESS OF KENYA'S MANUFACTURING SECTOR: THE ROLE OF THE INVESTMENT CLIMATE

KENYA

NOVEMBER 2004

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Acknowledgements

This Investment Climate Assessment (ICA) is based on an analysis of investment climate survey data conducted by the Kenya Institute for Public Policy Research and Analysis (KIPPRA) in Nairobi, Kenya and the Regional Program on Enterprise Development in the Africa Private Sector Group at the World Bank.

For helpful insights and analysis, we would also like to thank Vanessa Dick (EU), Ibrahima Diong (PPIAF), David Ferrand (DFID), Isaac Kamande (Kenya Ministry of Trade and Industry), Daniel Kanyi (APDF), Moses Kibirige (APDF), Julius Kipng'etich (Kenya IPC), Dorothy McCormick (University of Nairobi Institute for Development Studies), Catherine Masinde (DFID), David Mwangangi (KPSA), Ndiritu Muriithi (APDF), Kevin Njiraini (IFC), Fortunatus Okwiri (UNDP), Ocjeng Oloo (Market Intelligence), Gladwell Otieno (TI Kenya), and Terry Ryan (ACEG).

Michael Fuchs, and Andrew Stone served as peer reviewers for this work, and provided a number of suggestions and comments. Helpful comments were also received from Praveen Kumar, Makhtar Diop, Christiane Kraus, Manuel de la Rocha, Geoffrey Bergen, Axel Peuker, participants at the review meeting, and several members of the Kenya country team.

List of Acronyms

AGOA	Africa Growth and Opportunity Act
AIDS	Acquired Immunity Deficiency Syndrome
BDS	Business Development Services
CBK	Central Bank of Kenya
CBS	Central Bureau of Statistics
CCK	Communications Commission of Kenya
CEM	Country Economic Memorandum
CFR	Country Framework Report
COMESA	Common Market for East and Southern Africa
CWA	Collective Wage Agreement
DFI	Development Finance Institution
DFID	UK Department for International Development
EIU	Economist Intelligence Unit
EPC	Export Promotion Council
EPZ	Export Processing Zone
EU	European Union
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Services
FLSTAC	Financial and Legal Sector Technical Assistance Credit
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GJLOS	Governance, Justice, Law and Order Sector
GNI	Gross National Income
GoK	Government of Kenya
HIV	Human Immuno-Deficiency Syndrome
ICA	Investment Climate Assessment
ICT	Information and Communication Technology
IMF	International Monetary Fund
ILS	Integrated Labor Survey
IPC	Investment Promotion Centre
IP-ERS	Investment Programme for the Economic Recovery Strategy
ITL	Industrial Training Levy
KA	Kenya Airways
KACC	Kenya Anti-Corruption Commission
KANU	Kenya African National Union
KCB	Kenya Commercial Bank
KenGen	Kenya Electricity Generating Company
KIPPRA	Kenyan Policy Research Institute
KMES	Kenyan Manufacturing Enterprise Survey
KPA	Kenya Port Authority
KPF	Kenya Police Force
KPLC	Kenya Power and Lighting Company
KR	Kenya Railways
KRA	Kenya Revenue Authority
Ksh	Kenyan Shillings
LDP	Liberal Democratic Party
MoF	Ministry of Finance
MoL	Ministry of Labor
MoTI	Ministry of Trade and Industry
MSME	Micro, Small and Medium Enterprises
MUB	Manufacturing Under Bond
MVA	Manufacturing Value Added
NAK	National Alliance (Party) of Kenya
NARC	National Alliance Rainbow Coalition
NSE	Nairobi Stock Exchange
OECD	Organization for Economic Cooperation and Development
OLS	Ordinary Least Squares (regression)
PRGF	Poverty Reduction and Growth Facility
PPIAF	Public Private Infrastructure Advisory Facility
PSD	Private Sector Development
PSP	Private Sector Participation
RPED	Regional Program on Enterprise Development
SBP	Single Business Permit
SME	Small and Medium Enterprises
SSA	Sub-Saharan Africa
TFP	Total Factor Productivity
TI	Transparency International
TVET	Technical and Vocational Education and Training
ULC	Unit Cost of Labor
UNAIDS	Joint United Nations Programme on HIV/AIDS
UNCTAD	United Nations Conference on Trade and Development
US	United States (of America)

Executive Summary

1. **The objectives of the ICA are to assess the current performance of formal manufacturing firms, to identify the key constraints on their growth and competitiveness, and to prioritize and assess policy priorities to promote private sector development.**

2. **While attention is often drawn to the large and growing informal sector, the formal manufacturing sector remains of crucial interest because it is one of the largest and most productive sectors in the economy.** The formal manufacturing sector represents roughly 13 per cent of GDP in spite of employing less than 1.5 per cent of the workforce. Policies that promote improvement and expansion of the formal sector can therefore have a disproportionately large impact on national wealth. By size and rate of growth the informal manufacturing sector is larger—as a whole it employs roughly 40 per cent of the workforce, and more than three quarters of all manufacturing workers are employed there. These firms tend to be very small and unproductive, however, which is why the formal sector accounts for such a large share of GDP.

3. **The analysis of the formal manufacturing sector focuses on the analysis of data collected in a 2002/03 survey of 282 formal manufacturing firms and workers.** The survey covered seven sub-sectors in five urban areas: Nairobi, Mombasa, Eldoret, Kisumu and Nakuru. Up to ten employees from each firm were also surveyed. Roughly half of the firms have less than 100 employees, two-thirds are located in Nairobi, a fifth have a more than 10 per cent foreign ownership, half export more than 5 per cent of sales, and three-quarters are owned by ethnic Asians.

Assessing the competitiveness of Kenyan firms

4. **In general, Kenyan firms have a weak competitive edge over Uganda and Tanzania, but appear to be at a significant competitive disadvantage to strategic competitors like China and India.** Kenyan firms also pay more in bribes, provide more of their own infrastructure, and suffer under more regulation than Asian ones. Kenyan firms have only a slight productivity advantage, if any, over Tanzanian and Ugandan ones, and are at an increasingly severe disadvantage to Chinese and Indian firms. Labor is more productive than capital, and indeed appears better in Kenya than in the rest of East Africa. Yet in terms of overall firm productivity, Kenyan firms have little if any advantage over Tanzanian and Ugandan ones, largely because of its relative capital intensity. With little productivity advantage, Kenya's large trade surplus with East Africa is likely driven by size and perhaps historical and geographical advantages. Meanwhile, Chinese and Indian firms achieve similar or better labor productivity to Kenyan firms, but do so with much lower levels of capital. Kenyan productivity has been stagnating, moreover, while firms in India and China advance.

5. **Kenyan plants and equipment are outdated, overvalued and inefficiently used. Investment levels are low and declining.** Kenyan investment levels are very low after decades of decline. Most firms are investing nothing, and few firms that do invest spend enough to even replace worn-out equipment. Surprisingly, given their low rates of investment, firms' use of capital is relatively high and capital productivity low. Kenya's capital stock is unusually old, capacity utilization is poor.

6. **Productivity growth in Kenya has been zero or negative over the last twelve years.** Productivity declined by 0.5 per cent per year between 1991and 1998. Regression analysis of recent firm data suggests that, between 1999/2000 and 2002/03, almost no productivity improvement is visible in the average firm. There has been virtually no change in labor productivity. Capital seems

moderately more productive, but the increase is not statistically distinguishable from zero. Total factor productivity appears to have increased by 7% between 1999 and 2002, but again this estimate is not statistically different from zero.

7. **Increased trade openness has facilitated the rapid growth of a few internationally competitive firms and a rise in total exports. The average firm, however, is less internationally competitive and is now less likely to export.** With economic recovery and access to new markets through AGOA, COMESA and EAC, total exports have grown in the last few years. Firm data show, however, that since 1999 the average firm has become less likely to export. This suggests that the average firm is unable to compete internationally, and that the rise in exports is being driven by a few firms. Only firms in the textile sector have on average shown export growth, probably because of AGOA.

8. **Firms demonstrate an alarming indifference to and ignorance of the HIV/AIDS problem**. While the infection rate in the workforce is estimated at 15% nationally, more than half of all firm managers in the sample believed that none of their workforce was at risk. The other half, however, had programs to inform about or address the problem—a better performance than in Tanzania or Uganda. Most workers expressed a willingness to be tested, and even pay for that test.

Assessing the competitiveness of the Kenyan workforce

9. **Worker-level data suggests that the Kenyan workforce is relatively well-educated, with high returns to education.** The workforce in the sampled formal manufacturing firms is experienced, middle-aged and possesses a high level of education. Almost all workers have some schooling. There is a wide dispersion in earnings, driven largely by differences in education, experience, and industry. The average wage in the sample is equivalent to $261 per month, with unskilled production earning about $99 dollars per month.

10. **The level and quality of production and technical training in Kenya is low. This may be in part because the current training incentive system does not encourage firms to invest in enhancing production skills.** Firms appear to invest more heavily in managerial and professional training than in developing production skills. Training deficiencies can be traced, at least in part, to structural problems in the technical and vocational training system. The current training levy system is financially troubled and appears to be inadequate to firms' needs, as it does not support in-house training in production skills. There is sufficient international evidence to indicate that incentives to firms to increase in-house training are vastly superior to public provision of training.

11. **The cost of labor in Kenya is comparable to that in other East African countries, but appears strikingly uncompetitive with that in Asia.** Wages of unskilled production workers, at spot exchange rates, are higher in Kenya than all neighbours and strategic competitors. For instance, unskilled production wages in US dollars are twice that in India. Higher Kenyan wages are justified if labor and firms are highly productive. As seen above, however, capital productivity is lower than that seen in strategic competitors. Looking at estimates of the unit cost of labor (which accounts for wage premiums due to productivity) higher Kenyan wages appear justified when compared to the less labor-productive Tanzania or Uganda. Compared to Asia, however, the cost of labor still appears high.

12. **Real wages have doubled or tripled since 1994 while firm productivity has remained stagnant.** There is clearly a disconnect between productivity and wages that cannot be explained by the education or experience of the workforce. Minimum wages have been rising rapidly as well, but more slowly than the private sector average. Several possible reasons are suggested for this wage-productivity disconnect, including the possibility that regulation is driving low-wage jobs

into the informal sector, or non-market driven increases in public sector wages. Conclusive evidence on the matter will have to await the release of several ongoing labor market studies.

Assessing the competitiveness of the Kenyan financial sector

13. **Relative to other poor countries, Kenya has a well-developed financial sector and a falling cost of capital. A h**igh level of credit channelled to the Kenyan private sector relative to other low-income countries. Moreover, in the last two years, stability has return to the macroeconomy, lending rates have dropped, and banks have returned to profitability.

14. **While on the surface firms appear to be dissatisfied with the cost and availability of finance, finance does not currently appear to be a general and severe constraint to business.** While high interest rate spreads were undoubtedly a barrier before 2002, rates have fallen dramatically in the past eighteen months, lowering the cost of capital for most firms. Moreover, looking more closely at the data, one can see that access to finance is only an acute problem for a subset of firms, usually smaller domestic ones. Most firms do not feel credit constrained, and report that the reason they have not sought a loan is that they do not need one.

15. **While finance may not be a severe constraint, investment capital still may not be sufficiently cheap and available to enable the private sector to meet the government's ambitious investment target.** Interest spreads are still high relative to rich countries and emerging economies, and bank productivity is extremely low. Realistically, for the Government to reach their target investment rate of 23 per cent of GDP, interest rate spreads will have to decrease further, and capital will have to be made more available to small firms.

16. **Throughout the world, access to credit by smaller firms is limited by high transactions costs.** In Kenya, low productivity banks find it costly to evaluate and monitor small-value loans. The lack of public credit institutions (such as a rating agency) makes the evaluation of firm credibility very costly for banks, and dissuades them from lending to small enterprises. Moreover, deficiencies in the legal system hinder the enforcement of contracts, especially debt, and result in relatively high collateral requirements that small firms find slightly more difficult to meet. As a result, small firms (who are less likely to possess high-value collateral) face dramatically higher costs of lending than larger ones. Smaller firms generally report lower use of credit instruments, are less likely to apply for a loan because of cost and rejection fear, and are more likely to feel credit constrained.

17. **Transactions costs appear to be high, and the supply of credit appears to be limited, by the legal and institutional structure of the financial sector.** High interest rate spreads are drive by low bank productivity, the presence of many small banks, the difficulty of collecting debt contracts, and the high level of non-performing loans. These problems in turn have been traced largely to an inadequate legal and institutional structure, barriers to sector consolidation, and politically-motivated interventions.

Chief barriers to firm competitiveness: Corruption, crime and infrastructure

18. **Corruption is one of most significant barriers facing firms, especially foreign firms. More than half reported regularly having to make unofficial payments worth more than 6 per cent of revenues. Two thirds felt they were expected to pay bribes for government contracts.** Corruption was rated as a severe or major obstacle by three quarters of the sample firms, and respondents reported that "unofficial payments" to "get things done" are required 57 per cent of the time. Some of the worst offenders included the taxation authority, the health inspectorate, municipal authorities and utility companies. These payments were typically very costly. When firms reported a figure, bribe amounts averaged 6.1 per cent of annual sales revenue (two to three times

the level in Uganda or China). Of the firms that felt it was necessary to pay a bribe to secure a government contract, the value was typically 10% of the value of the service.

1.1.1 **Crime was the third most common complaint among firms, and a third of firms experienced a crime in 2002. The direct loss to crime is large (4 per cent of annual sales revenue) but the indirect cost of security (i.e. security measures) is also burdensome (2.7 per cent of sales).** A third reported an act of theft or arson in the previous year, with an average of 5 incidents per firm. Most firms also spent money on private security. Less than a fifth of the crimes were solved, and more than half of firms judged police services to be poor or very poor. Crime and insecurity also negatively affect the image of Kenya in the international investment community.

19. **Deteriorating transport infrastructure, especially in roads, rail and ports, cause firms to incur significant costs in trucking, vehicle repair, product delays and returns, and bribery.** Firms report high levels of dissatisfaction with transport infrastructure, especially roads and rail. These problems are perceived to be much more acute in Kenya than elsewhere in East Africa. A quarter of firms pay to build or repair local roads. Delays in delivery result in product refusals and returns of 2.5 per cent of sales. Port productivity is reckoned to be a third or half of the international norm, and perhaps six times as costly.

20. **Domestic and international investment is hindered by power difficulties. Firms lost nearly 10 per cent of sales to power outages, and two-thirds lost capital equipment to surges.** Firms experienced an average of 33 outages in a year, and most firms own their own generators to cope with power losses. Yet generators did not prevent damage to capital equipment and lost production time, equivalent to almost 10 per cent of sales. Electricity hook-ups and usage are also very costly relative to East Africa.

21. **Kenya's fixed-line telephone and Internet services are relatively costly and of poor quality due to the weak performance of Telkom Kenya. Mobile communications have dramatically improved access, but remain expensive.** Per minute charges are typically two to ten times that faced by rich nations. Quality is poor, and access is limited by long waiting times for connections. Mobile phone service is more widely and cheaply available, and mobile subscribers dwarf the number of fixed line subscribers. Yet mobile tariffs are still high.

Policy Implications

22. Kenya has several policy reforms underway. The policy discussion arising from this analysis is intended to preserve the momentum of ongoing reforms, while also making additional suggestions to raise productivity. Five major areas are addressed—quality of labor, access to finance, improvements in infrastructure, solutions to corruption and crime and improvements in the public-private dialogue. Specific recommendations include the following:

Labor

Review the performance of public sector training institutions with the objective of restructuring training systems as needed, and performing a Skills Needs Inventory as part of the restructuring of curricula and training capacities.

Restructure or replace the National Industrial Training Council to make it more autonomous and accountable to the private sector, and to upgrade the skills and qualifications of Council staff.

Broaden the scope of the ITL scheme, allowing specialized production skills training to qualify, especially in the high growth sectors (such as garments). Expand the range of skills and training institutions allowed to qualify. Enable firms and the Council to use international trainers until the shortage of qualified Kenyan trainers can be overcome. Encourage enterprises to offer training *to employees through additional incentive mechanisms, such as cost-sharing programs or tax breaks.*

Investigate a public-private partnership model for delivery of training, The 2004 Growth and Competitiveness Report suggests that Athi River Vocational Training Centre (AVRTC), which is currently functioning at a very low level of capacity utilization, be converted, on a pilot basis, into a dedicated training facility for the garments industry, with the Government providing institutional and financial support, and the private sector providing training content, knowledge and direction.

Expand the scope of and funding for the ILS. Focus ILS or WB study on question of wage growth, or commission a specific study. Have the CBS conduct an annual survey of workers and wage.

Postpone further broad-based public sector wage increases (beyond that of the inflation level).

Finance

Evaluate alternatives for building capacity in commercial banks to serve smaller enterprises.

Modernize key commercial registries to provide access to current, accurate, and reliable information.

Establish the legal basis for credit information-sharing among all financial service providers.

Remove barriers to creation, registration, and enforcement of security, and integrate the land registry systems, including the removal of hidden liens and excessive registration costs.

Reform and modernize insolvency procedures contained in the Companies and Bankruptcy Acts.

Strengthen capacity in the Commercial Court to achieve efficient case administration, and promote training among judges. Expand the specialized Commercial Court to other regions, including Mombasa.

Corruption and Crime

Increase the staff and financial resources of the Kenya Anti-Corruption Commission.

Develop and reinforce institutions to increase scrutiny of firm inspectors and regulators. Focus on agencies such as the taxation authority, municipal authorities, and utilities.

Enforce public officer codes of conduct more strictly and publicly, and with officials at the firm-level. Establish an anti-corruption authority or ombudsperson for the reporting and investigation of petty (firm transaction-level) corruption.

Establish systems for monitoring the impact of corruption reforms. Options include surveys of enterprises, households and other users of public services.

As discussed below and in the FIAS study, streamlining business regulation and procedures, by increasing the clarity, consistency and ease of regulation, will reduce opportunities for corruption in inspections and regulatory compliance.

Simplify and streamline the court procedures for commercial cases. Improve court recording and records management.

Increase the resources and appointing more Judges and Magistrates specialized in commercial disputes settlement.

Recruit new staff and upgrade the skills of existing staff.

Facilitate the registration of property liens and improve access to credit information to enhance debt recovery.

Introduce a small claims procedure to ease the pressure on court.

Strengthen alternative mechanisms of dispute resolution to ease the pressure on courts.

Target particularly problematic agencies and organizations (such as the taxation authority, municipal authorities, and utilities) for reorganization and increased scrutiny.

In order to reduce regulatory corruption, several general principles can be followed, including:

(i) minimize direct contact between public officials and firms by streamlining of regulations, the elimination or merging of inspections, automating and computerizing procedures, and increasing the use of third-party data and services;

(ii) rotate regulatory responsibilities, so that the same inspector or auditor is not permanently assigned to a firm; and

(iii) spread the regulatory process across more than one individual, department, or organization (such as a reorganization of a regulatory agency along functional lines) so that auditing, payments, customer service, and so forth are performed by more than one individual.

Implement broader strategies for addressing corruption in civil service organizations can also help, such as allowing independent internal and external audits, protecting whistleblowers, and giving firms a mechanism for complaining about harassment.

Keep up the momentum on current reforms of the Kenya Police Force. Examine viable alternatives for a transparent and meritocratic system for promotions and raises.

Infrastructure

Pass the privatization bill.

Fully implement the $225 million, donor-financed power sector project, including the development of an adequate policy, institutional and regulatory environment; expansion of power generation capacity; and better access to reliable electricity, as described above.

Accelerate preparations for the concessioning of major roads.

Increase the pace of road construction and repair, which has been criticized as slow.

Charges for heavy vehicles could possibly be increased and vehicle license collections improved.

Increase funding for maintenance of urban roads, especially in industrial parks and key urban access routes.

Complete the privatization of the Kenya Railways by means of a long-term concession.

Convert the Kenya Ports Authority into a landlord port authority. Private provision and competition should be introduced into all services. Clearance processes and customs procedures should be radically simplified to reduce the scope for discretion and rent seeking and to reduce costs to port users.

Public-Private Dialogue

Use existing fora for a public-private dialogue, while allowing KEPSA time to establish its usefulness to its member organizations. The National Investment Council can also serve as a key player in the dialogue on investment.

Develop objective measures of private sector performance and collect annual data on progress towards their improvement.

Create an independent "steering committee" for PSD policy made up of public and private actors to (1) make recommendations on the assignment of specific ministerial roles and responsibilities, (2) advise on PSD objectives and priorities, (3) make recommendations on PSD policy, and (4) publicly monitor and evaluate progress towards goals and create a donor-GoK-private sector coordination group to advise the steering committee.