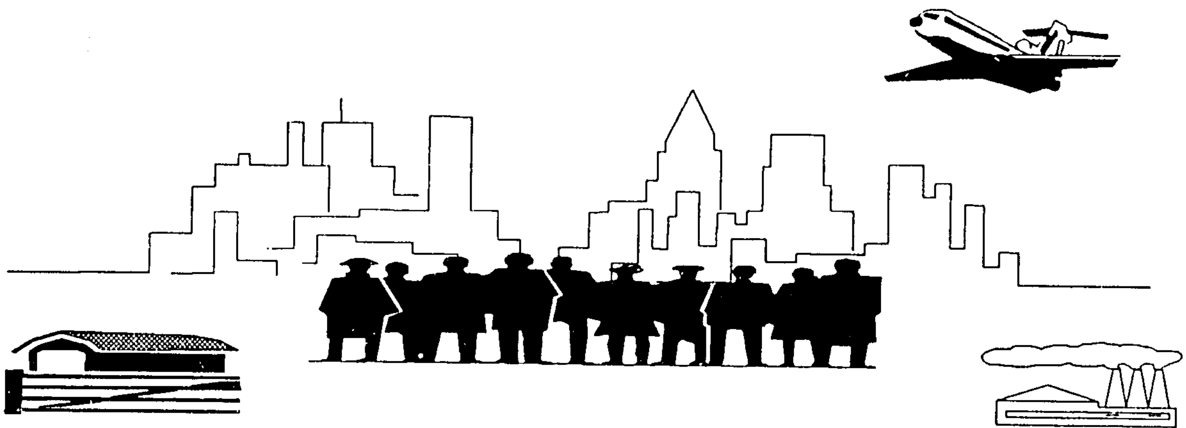

USAID/KENYA
PRIVATE ENTERPRISE STRATEGY

October 1990

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USAID/KENYA PRIVATE ENTERPRISE STRATEGY STATEMENT

USAID/Kenya's private enterprise strategy emerges from a series of sources: the needs facing the Kenyan economy, the overall strategy and goals of the Mission as expressed in its recent CPSP, the experience of the Mission in implementing its private enterprise portfolio in the 1980s, the priorities that have been set by the GOK, and the activities of other donors. This Strategy Statement describes in detail the salient features of the Kenyan private sector, explores the constraints to and opportunities for private sector growth, examines the policies and programs of the Government of Kenya and the other main donors in the private sector development area, and presents a conceptual overview of the private enterprise program. It also presents an objective tree and covers project, management and budget issues.

I. Background to the Strategy: Two Challenges

Kenya is unusual in sub-Saharan Africa for its relatively successful implementation of an inward-looking economic strategy and a public sector-led employment program. Over the 24-year period from 1964 through 1988, real GDP grew at an average rate of 5 1/4% per year. Like most African countries in the 1960s and 1970s, Kenya relied on quantitative restrictions and licensing arrangements to protect domestic industry and to generate a set of incentives geared to production for the domestic economy. Unlike most African countries (with the exception of the CFA Zone), Kenya did not succumb to the temptation to allow an increasingly overvalued exchange rate to contain measured inflation and thus sustain urban living standards at the expense of the rural population and, in particular, of agricultural exports.

Kenya's exchange rate exceptionalism was the result of two factors, one policy related and the other societal. First, Kenya has managed throughout its history since Independence in 1964 to sustain strong revenue performance in the tax system and to refrain from allowing spending levels to escalate to the point of generating severe fiscal deficits. Thus, inflationary pressures that would tend to overvalue the exchange rate have not developed. Second, the political weight of rural interests has been heavier in Kenya than elsewhere in Africa. This precluded Kenyan public policy from having the strong urban bias seen in other African countries. In particular, it generated political support for an exchange rate policy that would enhance the profitability of agricultural exports.[1]

In Kenya, the needs of rural producers generally have been heeded, both in terms of the provision of services and the orientation of trade policy. Thus, the GOK has actively promoted smallholder agricultural production (particularly in coffee and tea) and facilitated the concomitant growth of non-farm rural employment -- currently conservatively estimated at 8% of total employment.

The Kenyan experience of balancing an inward-orientation and public sector-led development with relatively prudent fiscal management and effective rural development policies precluded the declining urban-rural terms of trade, crippling levels of inflation, permanent balance of payments crises, and dramatic declines in governmental performance that have been so common in Africa. As a result, Kenya has not experienced the severe economic downturns that have marked most of the African continent. Rather, Kenya has been among the top economic performers in sub-Saharan Africa. This has been especially true in the 1980s, when most of the continent experienced economic stagnation or worse, while Kenya achieved an average annual growth rate of 4.2%.

Nevertheless, over time, the costs of the inward-looking and public sector-led development strategy have been growing, and have become increasingly clear to the GOK as well as those in the donor community, including USAID and the World Bank. These donors have long favored an alternative approach based on

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[1] This exceptionalism is not to say that Kenya's exchange rate management has been steady or that the Kenya shilling is not overvalued. After a fixed exchange rate for most of the 1970s, for example, a major devaluation of 36% occurred in 1981. More recently in 1988, an IMF review forced more active management of the exchange rate after a 3-year period of relatively little movement. Although the shilling has been devalued by over 41% against the dollar in the past three years, it is stil estimated to be overvalued. While Kenya's management of its exchange rate is commendable, there continue to be some distortions in the cost of capital vs. labor and imports vs. exports.

expanding the role of the private sector and increasing Kenya's competitiveness in international trade. In recent years, the inward-looking and public sector-led development has created two key problems:

1/ Limited employment generation in the private sector of the economy coupled with a rapid expansion of public employment, leading to declining real wages, and to the government becoming the employer of last resort for a whole class of highly educated Kenyans. This has exacerbated income inequality and generated unfortunate consequences for the GOK budget and for the efficiency of the public sector in general;

and

2/ An increasingly severe balance of payments problem as the import bill has grown at a rapid rate not nearly matched by the growth in export earnings. This has constrained production expansion and led the GOK to become dangerously dependent on donor resources (12% of GDP in 1989) in order to avoid potentially growth-crippling import compression.

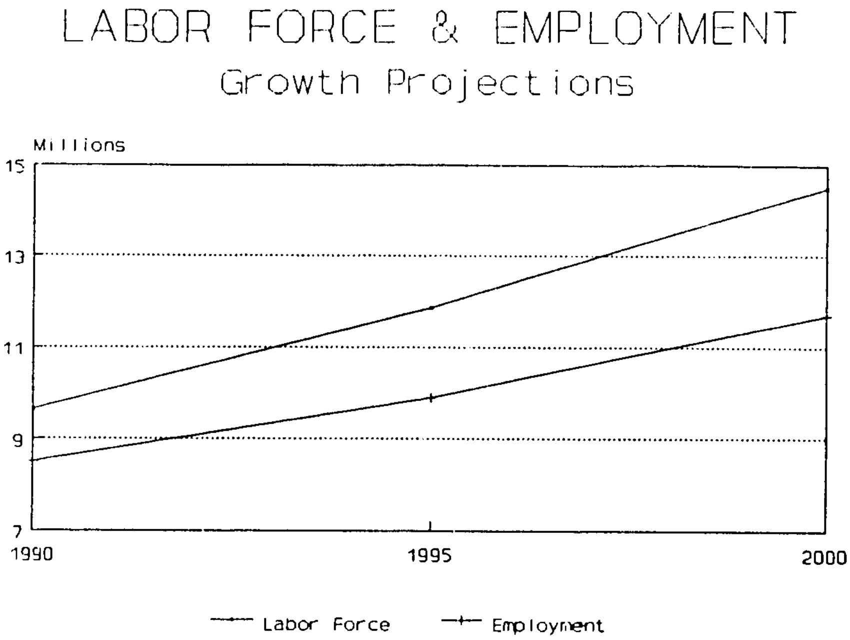
The next two sections illustrate the nature of these challenges in more detail.

I.A. The Employment Issue

Labor absorption is the central development problem facing Kenya as it looks towards the 21st Century. There are two underlying sources of the employment problem. The first, of course, is Kenya's very high rate of population growth. The fact that Kenya has long had one of the fastest growing populations in the world has meant that the high sustained rate of aggregate economic growth has translated into only a very modest (1 1/4% per year) increase in per capita income. The second is the inefficient utilization of labor in the Kenyan economy.

The various components of USAID/Kenya's programs all address elements of the labor absorption issue. Reducing the rate of population growth has long been a Mission objective and focal point of a number of projects. Recent data show that the rate of population growth is beginning to slow, from 4.1% in 1984 to 3.8% in 1989. The Mission's agriculture strategy seeks to invigorate rural labor absorptive capacity by increasing labor intensity per hectare through agribusiness support, agricultural research, and reduction of stultifying controls in agricultural marketing. Even if these activities are highly successful, the scarcity of arable land and continuing population growth means that the absorptive capacity of the rural areas will be increasingly stretched.

In many ways, the next two decades will be the most challenging in terms of the labor absorption problem. The labor force in Kenya is estimated to be 9.9 million persons as of 1990, and is projected to grow to 14.5 million by the year 2000. Of the 9.9 million labor force, only 1.8 million persons are engaged in wage employment, and less than 700,000 of these jobs are in the formal private sector. The formal private sector was only able to generate 50,000 new jobs last year, against 400,000 new entrants into the overall labor force. The number of new jobs required each year to accommodate the growth in the labor force will rise from 400,000 per year in 1990, to over 600,000 new jobs needed each year by the year 2000. The projected urban labor force growth of over 7% per annum is particularly striking and troubling. This growth derives from the continuing high birth rate, continuing rural to urban migration, and a rapidly rising rate of female labor force participation.



The need for the economy to provide employment opportunities for women will be especially important. Open unemployment of women in urban areas is already twice that for men. In the next five years, the female urban labor force will grow faster than that of the male urban labor force. If Kenya is to make productive use of its human resources, generating productive employment for women will be an urgent need.

Since Independence, the bulk of the task of absorbing the expanding labor force has fallen on the rural economy (in smallholder agriculture), on the informal sector and, increasingly, on the public sector. Over the 1978-88 period, 74 percent of all new jobs created were in smallholder agriculture, 10 percent in the urban informal sector and 12 percent in the urban modern sector. The informal sector, while a small share of total employment, has recorded substantial annual increases in employment, averaging 10 percent growth annually. In the 1980s, the rate of public sector job creation (5 1/2% per year) was more than twice that of the formal private sector. The following table illustrates the composition of the labor force by sector and indicates employment growth rates of each of these sectors over the 1974-1985 period.

SOURCES OF EMPLOYMENT GROWTH

		% of Total Labor Force (1985)		Employment Growth Rate (1974-85)
1. RURAL:			79	
Smallholder Agriculture		73		3.0
Rural Non-Farm		3		6.7
Modern Agriculture		3		1.8
2. URBAN:			19	
Modern Sector		12		3.9
(Public)	(5)			5.3
(Private)	(7)			1.7
Informal Sector		7		10.1
3. UNEMPLOYED			3	
4. TOTAL			100	

The GOK restrained public sector wage increases out of fear that these would send budget deficits skyrocketing and set off an inflationary spiral. Essentially, the GOK faced a trade-off between increasing unemployment or lowering standards of living in the urban areas and chose the latter. The GOK allowed a substantial decline of over 20% in the real wages of public employees. Formal private sector real wages have also declined, but only by about 10%. The largest drop in real wages, not unexpectedly, has been in the informal sector, which has absorbed the bulk of the large increase in urban population and in which wages are fully market-driven.

[This represents USAID/Kenya's real wage estimate based on a consumer price index (CPI) calculation which for the 1987-1989 period is two percentage points higher than the official GOK CPI estimates.]

There is mounting evidence that the GOK's approach of absorbing labor by creating public employment is having an increasingly adverse impact on the economy. While real wage levels have dropped, the total public sector wage bill has dramatically risen, both in nominal and in real terms. The expansion in public employment generated a precipitous rise in the percentage of total government recurrent expenditures on wages and salaries (70%, up from under 50% a decade ago) that has increasingly squeezed out necessary complementary expenditures on operations and maintenance. At the same time, the growing budget deficits, which are largely the result of the public sector-led employment strategy, are a major source of recent inflationary pressures in the economy. Those pressures now threaten the country's hard-won overall macro-economic stability. The GOK is facing a scenario in which, unless job creation is successfully shifted to the private sector, both increasing unemployment and further lowered real wages are likely.

The reasons for the formal private sector's poor performance in generating employment opportunities are clear. Overvaluation of the exchange rate and subsidization of capital, although not as extreme as in other African countries, have tended to impart a bias toward capital-intensive production processes despite a factor endowment characterized by scarcity of capital and abundance of labor. Moreover, opportunities for business expansion in the formal sector have been constrained by quantitative import restrictions, monopolistic licensing practices, general bureaucratic obstacles, and spreading corruption. The result has been capital flight, the shift of investment toward real assets, and growing inefficiency of investment which, taken together, result in both a lower rate of overall economic growth than should be the case and in a poor record of growth in productive formal sector employment, which has severe equity implications for the country.

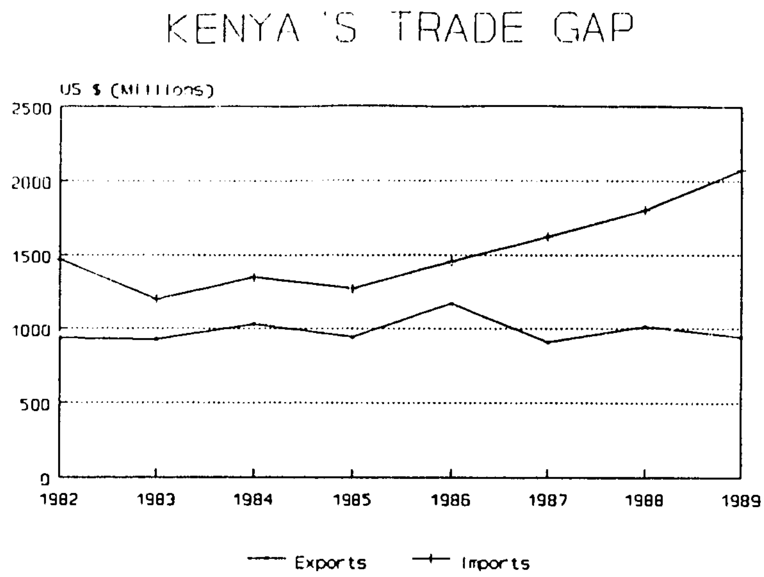
Over the next decade, with the urban labor force projected to grow at a 7 percent annual rate and the Government committed to holding public sector employment growth constant, the urban private sector must become the catalyst for job creation. The informal sector is expected to continue to absorb excess labor but cannot be expected to be the engine of growth.

In the rural economy, a continuation of 3 percent annual growth in smallholder employment will require labor intensification of production. Over the past two decades, a large share of smallholder job creation has been due to increasing the land area under production. Kenya has now reached its effective limits in increasing high potential land under production. Future labor absorption will come only from more efficient cultivation of food crops and, more importantly, from a shift to labor intensive cash crops for export -- particularly horticultural commodities.

I.B. The Balance-of-Payments Issue

Kenya has seen its foreign exchange reserves reduced substantially (from some $400 million in 1985 to well under $200 million today) as a result of weakened export earnings and increasing import costs. In the past five years the import bill has grown from $1.4 billion to $2.1 billion, while export revenues have stagnated at roughly $1 billion per year. The increase in imports is largely attributable to public sector imports for government consumption, military purchases and development infrastructure projects.

Lower oil prices (until the mid 1990's) and rapidly increasing tourism receipts have substantially offset import growth; nonetheless, only through a large increase in foreign assistance (from 5% of GDP in the mid-1980s to over 10% of GDP in the late 1980s) has the GOK been able to avoid a very serious balance-of-payments crisis. The increasing pressure on the country's external balances, while immediately caused by weak international market conditions in Kenya's traditional exports of coffee and tea, and soaring oil prices, is the cumulative result of Kenya's sustained implementation of an inward-oriented development strategy. As in most countries, Kenya's inward orientation did nothing to alleviate its import dependence.



Poor export performance has its roots in the GOK's inward-looking development strategy. Restrictions on imports combined with restrictive licensing practices generated a set of incentives for entrepreneurs that made production for the domestic market both more profitable as well as less risky than production for the export market. A recent survey done by the Kenya Association of Manufacturers found that this anti-export bias was still in place despite recent moves towards trade liberalization and improvements in incentives for exporters.

I.C. Evolution of GOK Development Plans

The Kenya Government's formal approach to the private enterprise sector was articulated shortly after Independence in its seminal Sessional Paper #10 of 1965 titled "African Socialism and its Application to Planning in Kenya." Sessional Paper #10 described the Government's philosophy of a mixed economy, combining African socialism with Kenyan entrepreneurialism guided by government intervention. Over the 1965-1980 period, this philosophy encouraged the Government's increasing interventions in the economy, particularly the establishment of over 200 parastatals and marketing boards and the placement of controls over both producer and consumer prices for a wide range of commodities.

Even with the Government's increasing interventions in the private sector, the economy was able to sustain rapid growth for the first fifteen years after Independence, underlining Kenya's effective management and its inherently strong resource base. This growth also was aided by the presence of the East African Community, which allowed for free trade between Kenya, Tanzania and Uganda. The Community effectively extended domestic marketing of commodities to this three country area affording Kenyan producers a substantially larger market to service than they had following the final collapse of the Community in 1977. As Kenya entered the 1980's, its inward-oriented trade strategy and public sector-led employment strategy began to reach their effective limits and Kenya experienced its worst economic crisis since Independence. In the early 1980's, double digit inflation and growing budget and trade deficits forced the Government to rethink its economic strategy and particularly its control of the private sector.

In 1986 the GOK adopted a plan to massively restructure the economy. Sessional Paper #1 titled "Economic Management for Renewed Growth" was a visionary statement for the Government of Kenya as the first clear commitment to a radical shift in the structure and orientation of the economy. The Sessional Paper recognized that the potential for domestic demand-led growth in the economy is limited and that the maintenance of the inward-oriented strategy would result in lowered growth, inadequate job creation, continued downward pressure on wages and incomes, and chronic balance of payments difficulties. The Paper proposed the evolution of the Kenyan economy away from its inward orientation towards a more outward approach.

Despite the adoption of Sessional Paper #1, the pace of evolution of GOK policy has been slow. In part, this has been the consequence of entrenched interests in the existing economic structure. In part, it was the result of an underestimation on the part of the GOK of the depth of the problems it faces and of the breadth of the policy changes that will be needed to implement the vision presented in Sessional Paper #1. In fact, it was not until 1989 that the issues of strengthening the role of the private sector in employment generation and more effectively promoting exports made it to the top of the GOK's policy agenda.

In response to the pressing need for employment generation, the Kenya Government has articulated a new employment strategy that gives the private sector the leading role and attempts to stem the decline in real wages while maintaining high levels of employment creation. This strategy focuses on further integrating Kenya into the international economy and reforming the regulatory environment to improve the efficiency of investment, in addition to the traditional aim of increasing effective demand in the domestic economy. The GOK now envisions that both the formal and, especially, the informal, private sector will take over from government the main responsibility for providing new jobs. This strategy has been fleshed out in a series of documents, including the Sixth Development Plan (1989-1993) and the GOK/ILO/UNDP study entitled A Strategy for Small Scale Enterprise Development in Kenya: Towards the Year 2000. The Policy Framework Paper 1990 - 1992 sets a series of targets for reducing public employment, including the withdrawal of the government employment guarantee for graduates leaving universities and other government training institutions.

The weakness of Kenya's export sector has also been recognized as a major component of the employment problem. Recently, the GOK's Commission on Employment has concluded that only through shifting to a more outward-oriented development strategy can Kenya address its burgeoning employment needs. Similarly, the theme of the 1990 Budget Speech, presented in June by Vice-President and Finance Minister Saitoti, was "Enhanced Economic Growth Through Export Promotion." The Government has articulated an export-promotion strategy that combines the creation of export enclaves, via export processing zones, with reforms, such as a duty exemption scheme, that are designed to improve the environment for exporting in the economy as a whole.

While an intellectual consensus has clearly been achieved on the need for a private sector-led employment strategy, the transition involved is very difficult to undertake, and is, in fact, only in its very early stages. Experiences in other countries undertaking the transition from a public sector to a private sector-led employment strategy suggest that it will involve technically difficult, controversial, and painful policy choices. The need to challenge entrenched ideas and interests will make the transition difficult to sustain and will demand the creation of a new and very different relationship between the Government and the private sector.

Likewise, there is strong evidence of a clear intellectual consensus across the GOK and private sector in general on the need for a transition from an inward to an outward orientation of the economy. But, as in the case of the shift in the employment strategy, the transition from an inward-looking to an outward-looking development policy is analytically difficult, poses political risks, and is difficult to implement. The initial phase of this transition in Kenya has emphasized import liberalization[2], both to promote greater efficiency in domestic-oriented production and to reduce the bias in the

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[2] Import liberalization has consisted of expansion of foreign exchange availability for imports, reduction of quantitative restrictions and progressive reduction of import tariffs, especially on raw materials and intermediate production goods.

economy against exporting. While the import liberalization program has been successful in simplifying the structure of protection in Kenya and beginning to diminish the biases against exporting, it has only led to limited expansion and diversification of exports. On the other hand, the increased donor resource flow that has supported import liberalization has financed the rapid increase in imports, with the ironic results that Kenya now faces a substantially worse balance of trade situation than it did at the very beginning of the transition to a more outward-oriented strategy. Thus there is the pressing need for increasing the economy's foreign exchange generating capacity along with an emphasis on employment creation in the productive sector.

The GOK now realizes that it must change the enabling environment for private enterprise growth so as to better use the nation's most important development resource, the Kenyan people. The Government is committed in its Development Plan, policy statements and programs to decreasing the size and role of the public sector and to encouraging the private sector by decreasing burdensome regulations and by expanding its access to financial markets. The level of consciousness and commitment to transformation of the economy first enunciated in 1986 has spread throughout the highest levels of government and is supported by pressure from private entrepreneurs and the institutions which represent them. This theoretical proclivity will now be translated into action due to the twin crises facing the GOK -- unemployment and negative balance of payments.

Implementation of these structural reforms, however, will be neither easy nor smooth. Not only are the policy and implementation reforms the Government needs to undertake ambitious, there still is an overhang of concern over the political climate and corruption that colors investor attitudes and affects perceptions of the enabling environment for private investment and enterprise growth. However with the commitment of the Government of Kenya to restructuring of the economy and the reforms already enacted, along with an enclave approach as the initial model for export development, positive signals are being given on investor protection and investment facilitation. (The investment climate and corruption issues are discussed in detail in Annex F to this paper, <u>Description of the Productive Sector in Kenya.</u>)

USAID, with its involvement in the private enterprise sector in Kenya and successful experience in implementation of similar structural adjustment programs elsewhere in the world, is uniquely suited to assist the Government of Kenya and the private sector in restructuring the orientation of the economy.

II. USAID Private Enterprise Strategy

The USAID/Kenya Private Enterprise Strategy for 1990-95 is based on the conviction that the private sector can and should be the engine of economic growth in Kenya, and that the Government of Kenya is serious in its commitment to private sector-based development. The Strategy evolves from lessons learned in ten years of implementing private enterprise projects and from experience with a strategy first articulated in 1985. The strategy takes advantage of shifts in GOK priorities over the past decade to branch out into new areas of emphasis, and recognizes the key role of the policy environment and incentives to private enterprise growth. At the same time, the growing involvement of other donors in private enterprise development provides an opportunity to consolidate and focus the strategy.

II.A. Rationale for Private Sector-Led Growth

The GOK's new commitment to the private sector as the engine of growth for the economy flows from its demonstrated efficiency in comparison to the Kenyan public sector, the successful example set by the Newly Industrialized Countries (NICs) of South-East Asia and comparative advantages that suggest opportunities for further expansion. With the support of the IMF and World Bank, the GOK has embarked on effective stabilization and structural adjustment programs that provide a sound basis for economic development. Furthermore, as discussed in the previous sections, the GOK recognizes and is committed to making the policy reforms necessary to improve the enabling environment for private sector growth.

The private sector currently contributes approximately 75% of GDP, 89% of total employment and 60% of wage employment in Kenya. The formal private sector contributes 69% of GDP and 40% of wage employment. It absorbs 60% of fixed capital investment. It is hence an efficient generator of output per investment, though less efficient in generating employment. The informal private sector's contribution to employment has doubled since 1980. This sector has absorbed more labor during the 1980's than any other segment of the economy.

Working with the World Bank, the International Monetary Fund and several bilateral donors, the Government has attained considerable success in the last several years in both stabilizing fiscal and monetary policy and providing incentives for private enterprise growth. Macroeconomic reforms which have improved the environment for private enterprise growth include:

* Decontrol of prices, decreasing the number of controlled items from 43 in 1988 to 18 in 1990, and setting more realistic prices for those remaining items.

* Maintaining relatively competitive exchange rates through continual devaluations of the shilling;

* Liberalizing the import regime, replacing quantitative restrictions with duties, gradually harmonizing and reducing the duties.

* Stabilizing domestic imbalances through monetary and fiscal policy, thus substantially reducing the budget deficit between 1985 and 1989.

* Strengthening and restructuring the banking system, increasing Central Bank oversight and enhancing depositor protection.

For most of its history Kenya has been content to compare its performance in stabilization, adjustment and economic growth with its African neighbors and has been rightly proud of its accomplishments. However, with its growing self-confidence, the GOK has increasingly looked elsewhere in recent years for successful examples of employment generation and balance of payments management. The GOK has focussed on the spectacular growth of the NICs. Based in part on their example, the GOK has announced a number of reforms (included in the recently signed Policy Framework Paper with the IMF and the World Bank) which are intended to further enhance the environment for private sector export-led growth. These reforms are in various stages of implementation and include:

* Interest rate decontrol by June, 1991;

* Improve marketing and efficiency of the National Cereals and Produce Board (NCPD), reducing the financial burden and limiting the role of the NCPD.

* Liberalize the export regime, establishing a duty drawback/exemption scheme, establishing export processing zones, providing firm-level assistance and reducing the regulatory burden on exporters.

* Prepare, for the first time, annual public investment budget with IDA assistance.

* Restructure state-owned corporations, with Phase I focusing on developing a GOK policy framework, implementing a performance and monitoring system and identifying 20-25 parastatals for divestiture.

* Increase cost sharing in social sectors, focusing on health and education.

* Support and assist the GOK in developing a strategy for natural resource management and support financially the Kenya Wildlife Service.

Finally, Kenya has comparative resource and market advantages that position it well to respond to an improved enabling environment for private enterprise growth. Most obvious of these advantages are:

* A large, low-cost, skilled and easily trained labor force.

* Extensive transport and communications links that make it the regional business and commercial center for East Africa.

* Preferential market access to the EEC, North America and the PTA region.

* Fertile land, productive year-round, though largely fully utilized at present for coffee, tea and subsistence food crops.

* Pleasant climate, beautiful beaches, extensive concentrations of wildlife and adequate infrastructure that make it the top tourist destination in Africa.

With these advantages, Kenya has significant potential to expand economic activity in agribusiness, fresh horticulture, light manufacturing and tourism. Expansion of horticulture and agribusiness are dependent on the ability to shift land utilization from food crops, coffee and tea, to high yielding crops which can be directly exportable or processed to make high value-added export products.

With the Government's realignment of economic policy to outward-oriented, export-led growth comes enhanced potential for employment absorption, as pressures increase to move toward more efficient (more labor-intensive) production processes. This potential will be reflected directly in labor intensive export industries, and indirectly through the small and medium scale enterprises that will feed the export operations. The effective employment uptake in productive private enterprises will reap not only political stability benefits but also needed foreign exchange and the GDP growth rates so necessary to the country's economic health.

The focus on private enterprise will complement the development of private sector agriculture. Agriculture's contribution to GDP is near 30%, however the annual growth in the sector has only been 3% in the 1980-1988 period (down from 5% in the 1965-1980 period). With a decline in land availability per capita from nearly a hectare at Independence, to a third of a hectare today, there is limited capacity to absorb additional employment in traditional farming. The GOK, cognizant of these constraints to agriculture, is emphasizing overall private sector growth, but export-oriented private enterprise development in particular, as the key to employment uptake and economic recovery.

II.B. Related Programs of Other Donors

The International Monetary Fund, World Bank, African Development Bank, Japan, UNDP, Germany and the Nordic countries all have assistance programs that touch on private enterprise development concerns. While USAID has been the lead donor on direct private enterprise assistance, increasingly other donors have become involved, particularly in macro-economic issues and assistance to the informal sector. This has allowed the Mission to focus our new strategy and planned interventions.

The International Monetary Fund provides approximately $100 million annually to Kenya and is primarily responsible for ensuring the GOK continues to maintain macroeconomic stability by achieving specific monetary and fiscal benchmarks agreed to each year. The Fund is also concerned with the Government's balance of payments situation and closely monitors monthly foreign exchange reserves. The Fund is directly strengthening the private sector by forcing the Government to decrease its share of borrowing in the credit markets and ensuring that Kenya's exports remain competitive through an appropriate exchange rate.

The World Bank is pursuing a wide-ranging structural adjustment effort with the GOK, based on sector adjustment programs and an overall budget rationalization/public investment program. The Bank is providing $210 to $220 million per year to Kenya and could increase the level to $240 to $240 per year if the GOK pursues a more vigorous parastatal reform/divestiture effort. The Bank is strengthening the private sector's ability to absorb labor and take a leading role in economic growth by tackling five major structural programs including: 1) reversing the economy's anti-export bias, 2) strengthening the investment climate, 3) reforming the extensive and inefficient parastatals, 4) reforming agricultural sector policy and 5) widening and deepening the financial markets.

The African Development Bank and Japanese are also playing a significant role in supporting private sector reforms by co-financing World Bank sector adjustment operations in industry, and finance and could provide assistance for the Bank's export development credit.

A number of donors, including UNDP, Germany, and the Nordic countries, have small programs with the informal sector and small scale enterprises. These programs have focused on training and credit, often using the Kenya Industrial Estates (KIE) parastatal as the executing agent. These donors are expected to continue their activities with the informal sector and small scale enterprises.

A more detailed description of other donor activity and a chart depicting the various activities of other donors in private enterprise development are included in Annex E.

II.C. Evolution of USAID's Strategy

USAID/Kenya's 1985 Private Enterprise Strategy Statement was one of the first comprehensive private sector strategy documents to be prepared by an A.I.D field mission. It described macroeconomic constraints, prerequisites for growth of the private sector and six critical interventions necessary to accomplish its objective of increasing the role of the private sector in the Kenyan economy. Five of these interventions -- Finance, Managerial and Entrepreneurial Skills, Technology and Technical Skills, Investment Promotion, and Informal Sector Assistance -- are addressed by the current program. The sixth element of the strategy -- Export Promotion -- was not actively pursued in the 1985-1990 period because of a lack of GOK or private sector support. The strategy was reviewed in a major Manual for Action in the Private Sector (MAPS) exercise in 1989.

Most of what the 1985 strategy laid out is still accurate. However, there have been changes in GOK policy since that time and the Mission has used the accumulated experience from A.I.D. and other donor programs and the results and recommendations of a program evaluation and the MAPS exercise to prioritize and focus the current strategy and proposed interventions.

Key lessons which have influenced the revised strategy are:

* The difficulty in measuring progress of the program toward achieving an overall objective of increasing the role of the private sector in the economy. Through 1989 the program measured impact by results on employment, sales and asset increases for enterprises directly assisted by project activities. The linkage between the direct assistance and the performance of the overall private sector economy was tenuous at best. More recent attempts to measure investment

levels and productivity of investment have been unsuccessful, primarily because few statistics are available, and those are distorted by the inclusion of parastatal activity. The revised strategic objective will be measured by employment and wage indicators for which considerable data is collected routinely by the GOK.

* The difficulty of generating significant increases in employment through growth stimulated only by domestic demand. The revised strategy targets new emphasis on export promotion to stimulate economic (and employment) growth to meet demand from foreign markets as well.

* The difficulty in establishing sustainable informal sector activities. The revised strategy targets segments of the economy where sustainable interventions are possible.

* The limited potential of the informal sector to contribute to the economy or to absorb labor without an erosion in wage rates. Employment growth in the informal sector during the 1980's is not so much indicative of its unlimited potential, but rather symptomatic of the barriers to entry into the formal sector and of the disincentives to productive investment in a protected, inward-looking economy. The increasing informal sector interventions by the GOK and other donors provide USAID with an opportunity to focus its efforts on other more promising segments of the economy.

* Restrictive policies have constrained the effectiveness of direct firm level assistance provided under the current program. One example is financial market development activities. Key policy factors are interest rate and credit ceilings, and the lack of a dynamic stock market or transparency in business financial reporting. Given these constraints, USAID programs to introduce and demonstrate small-scale lending practices and medium-term credit facilities in the commercial banking sector have accomplished little permanent behavioral changes. Future programs will concentrate first on restrictive policies, limiting direct interventions to areas where temporary resource or skills gaps are clearly identified.

II.D. Strategic Objective and Targets for 1990-1995

The basic thrust of USAID/Kenya's private enterprise strategy is to increase productive employment by improving the efficiency of non-farm private sector investment and labor absorption. The strategy relies on more open internal and external markets to provide opportunities to expand and diversify production. Open and competitive markets will allow Kenyan enterprises to respond to these opportunities with more efficient capital investments and utilization of labor. Competitive and productive enterprises are able to pay higher wages that will slow and reverse the erosion of real wages that has occurred during the 1980's.

Strategic Objective: Increase Private Enterprise Employment While Reversing the Decline in Real Wages

The rapid growth of the labor force in Kenya has outstripped the economy's ability to absorb this labor productively. As a result, labor absorption has been concentrated primarily in the public and informal sectors, resulting in employment at declining real wages.

In order to meet the needs of a rapidly growing labor force, the private sector must play a more central role in the labor absorption process. The USAID program is designed to increase private sector employment at constant or rising real wages.

The program will accomplish this objective by facilitating the shift from an inward, import-substitution orientation on policy and incentives to an outward-looking, export-promoting set of incentives, and by facilitating the transition from relying on public sector employment to "take up the slack" in the labor market to a regime that relies on the private sector as the principle source of new jobs. Each of the two targets of the private enterprise strategy corresponds to one of these fundamental transitions.

Target 1: Increase Non-Traditional Exports

The first target of the strategy, to increase non-traditional exports, is designed to support the transition from an inward to an outward oriented economy. Production to satisfy domestic demand is not growing as fast as the labor force. Significant increases in labor absorption will require a shift toward producing for export markets and maximizing the multiplier effects through backward linkages to the domestic economy. The success of the shift to a more outward orientation will depend upon the Government's improving the overall investment climate in order to encourage the private sector, both domestic and foreign, to expand their investments in export enterprises. Sustainable export production will require diversification away from the current reliance on the traditional agricultural export commodities.

Non-traditional exports are defined as products and commodities other than coffee, tea, and petroleum products. The focus on non-traditional exports is justified by the heavy other donor involvement in the coffee and tea subsectors and constraints analyses that show continuing declining terms of trade for the traditional agricultural commodities. Petroleum products are pass through re-exports of refined raw material imports, hence they are classified along with coffee and tea as commodities which will not benefit substantially from our export development activities and which are not a target of our program.

Subtarget 1a: Improve the Policy Environment for Exports

USAID, World Bank, and GOK analyses show that an anti-export bias exists in the economy and that it must be neutralized if Kenya is to generate sufficient employment to meet the needs of the rapidly growing labor force. This anti-export bias is created by, inter alia, price and foreign exchange controls, tax policies, import restrictions and tariff levels and administration. USAID and the World Bank will work with the government to eliminate this bias.

Subtarget 1b: Expand Support Services for Exporters

In addition to policy changes and program support, the success of a Kenyan export drive will in part depend on the ability of firms to take advantage of new opportunities. Services such as marketing information, pre-export financing and technological assistance are lacking, especially for smaller and new exporters. USAID will provide a multifaceted program of firm-level assistance to enhance the private sector's ability to rapidly respond to the improved policy and regulatory environment.

Target 2: Increase the Profitability of Small and Medium Enterprises

The second target of the strategy is designed to support the transition from public sector to private sector led labor absorption.

The success of private-sector employment creation in general will depend upon improving the profitability of enterprises by removing regulatory and tenure/access impediments to production and trade. The strategy focuses on small and medium enterprises because they are most directly affected by these external impediments and have been under-served by existing financial, advisory and advocacy institutions. Also, most importantly, small and medium enterprises (those firms which are above threshold level and employ up to 100 workers) are more labor intensive than current capital-intensive large enterprises in Kenya. SME's as well are more able to provide jobs at increasing real wages than informal sector enterprises. In short, SMEs are a critical source of increasing labor absorption at rising real wages, and are in the best position to push for, receive, and apply productively the benefits that could be offered by existing institutions given an improved policy environment. Strengthening of the SME subsector will provide necessary depth to the private enterprise sector, ethnic balance with opportunities and resources directed to African entrepreneurs, and important backward linkages from the export operations into the domestic economy.

In addition, the support for SMEs envisioned in the strategy is not only more cost effective and sustainable than programs for the informal sector, but also makes informal enterprise "graduation" both more desirable and possible by increasing SME profitability while simultaneously reducing barriers to entry.

The Mission strategy is to provide a catalyst to help "jump start" the SME sector by reducing regulatory impediments and assisting the development of support services for SMEs.

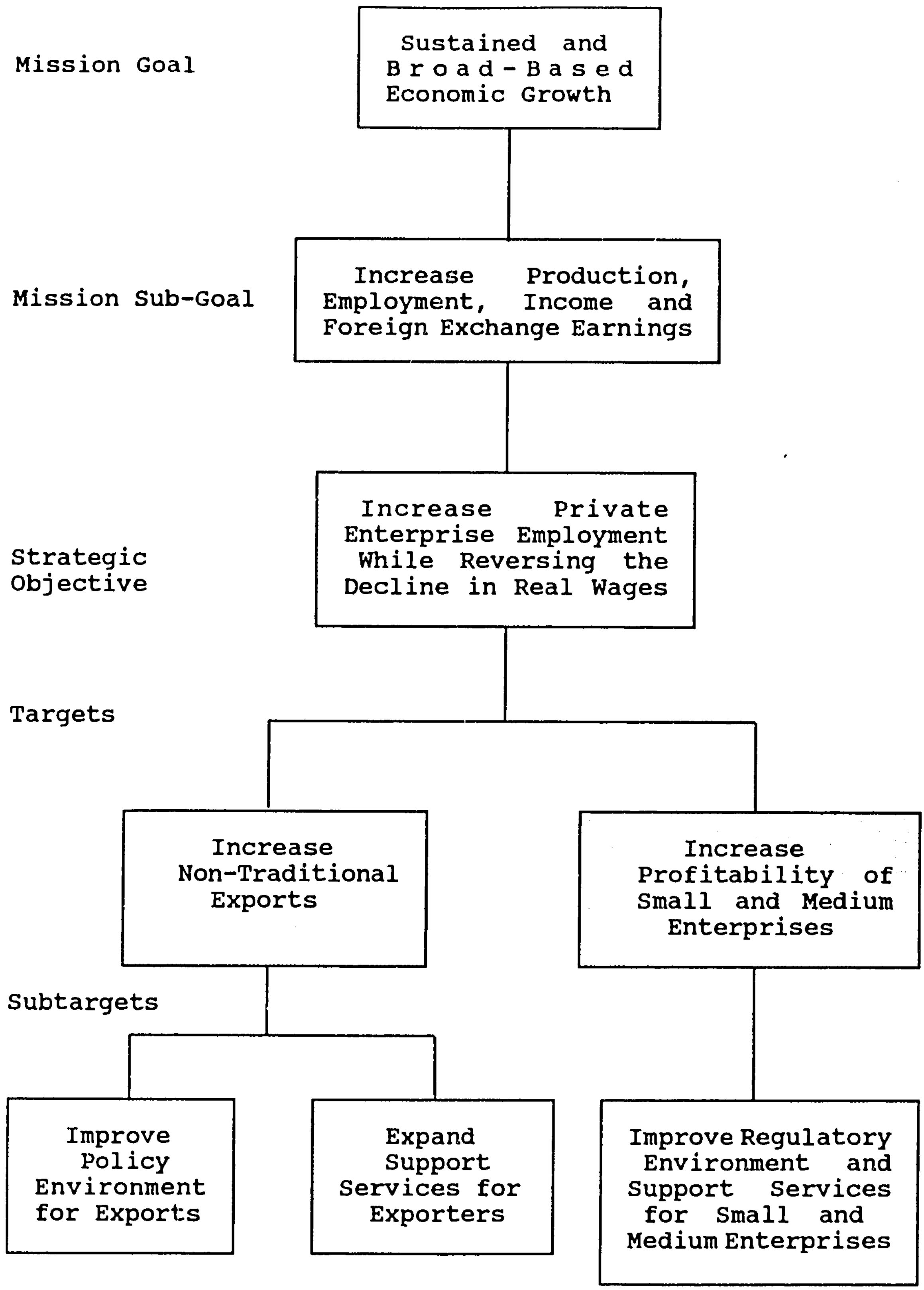
Targeting SMEs will promote greater stability in the productive sector by providing support for indigenous and women-owned enterprises. This stability is essential to creation of a conducive investment climate and to provision of a cadre of entrepreneurs, products and services to meet domestic demand and to support export enterprises.

Support to small and medium enterprises as one of the two targets of our program capitalizes on the successful experience the Mission has had over the last five-year strategy period as the lead donor involved in this sector. The programs in this target area are largely ongoing, and our support is considered transitional as the implementing institutions move toward self-sustainability and/or other donor sources of support.

<u>Subtarget 2a</u>: <u>Improve Regulatory Environment and Support Services for Small and Medium Enterprises</u>

In order to increase the profitability of SMEs, restrictive licensing and credit related regulations must be relaxed, and SMEs must be in a position to take advantage of these changes. USAID's efforts to improve the regulatory environment will be targeted to complement the work of other donors in this field by helping to strengthen local private sector advocacy institutions. Direct service provision to and through private sector organizations will help to insure that the resulting changes can be capitalized on by SMEs.

PRIVATE ENTERPRISE OBJECTIVE TREE



III. PROPOSED PROGRAM

USAID/Kenya manages perhaps the largest, broadest and most mature A.I.D. private sector program in Africa. From pilot activities in microenterprise lending in 1980 and a first bilateral project in 1983, the program has grown to now include activities with total funding in excess of $122 million (see Annex C Table 1). Significant efforts are underway in three general functional areas: policy dialogue and investment promotion, financial and equity markets development, and management and entrepreneurial assistance and training. The experience gained in managing this portfolio and the results of a major program evaluation conducted in 1989 have provided the Mission with a wealth of lessons learned and recommendations for future actions in the sector.

III.A. Lessons Learned from Ongoing Projects

Key lessons which have influenced the subtargets in the strategy and the proposed interventions are:

* USAID's indirect approach to policy dialogue in the current program has been effective. Moreover, A.I.D. has established sufficient credibility with the GOK and intermediaries to become more directly involved. Currently, policy dialogue is carried out by intermediary organizations that develop their own policy agendas and carry out policy studies by contracting outside consultants with A.I.D. financing. The 1989 evaluation of the private enterprise program considered the policy dialogue activities to be extremely effective. Studies conducted by the Kenya Association of Manufacturers, for example, were observed to have been the basis for GOK decisions to streamline and eliminate regulatory controls on businesses. The evaluation recommended additional resources for the indirect policy dialogue and, in addition, more direct involvement by A.I.D. in the process. In recent months, USAID has been more direct in engaging the GOK, World Bank and the Kenya Association of Manufacturers in a policy dialogue concerning export issues which has resulted in a common understanding and preliminary plans for complementary A.I.D. and World Bank assistance programs. A mix of direct and indirect approaches to policy dialogue will be used to implement future programs.

  A major strength of the current program is the synergy between different program elements. Projectized assistance has provided quick feedback on the impact of policy reform measures and increased A.I.D's ability to engage the GOK in a credible policy dialogue. Financial and equity market activities are effectively supported by training and technical assistance. They and the investment promotion activities serve to highlight continued policy constraints. Training, study tours and technical assistance contribute to policy institution building. Future activities will continue to include a mix of synergistic interventions.

Demand for the management and entrepreneurial assistance and training provided under the current program is high because the impact is clear. For example, a selection of program clients have cut costs by as much as 25%, increased production by as much as 79%, and increased sales by as much as 150%. The firms and individuals assisted have also shown a willingness to pay for a significant portion of the services. Future programs will continue to provide assistance to firms on a cost-sharing basis until the services sector develops effective, commercially available programs of its own.

III.B. Planned Interventions for 1990-1995

The nature of the problems involved in improving the efficiency of labor absorption by facilitating Kenya's shift to an outward-oriented, private sector-led development strategy suggests a multi-faceted approach for the Mission. The portfolio will devote efforts both to improving the policy environment and to improving the capacity of firms to respond to the enhanced environment through increased technical capability and through the removal of resource bottlenecks.

Efforts to address subtarget 1a, Improve the Policy Environment for Exports, include:

1/ Non-project assistance to facilitate crucial, but technically and politically difficult, policy changes that the GOK wishes to undertake. This responds to the GOK difficulty in articulating and implementing specific policy changes to transform general preferences into reality.

2/ Technical assistance to the GOK to support both the implementation of policy change and to enhance long-term ability to respond to issues involved in the two transitions. This responds to difficulties in the implementation of policy change and lack of a long-term perspective by the GOK.

3/ Institutional support to private sector organizations to enhance their capacity to both provide direct support to Kenyan businesses and to increase their ability to engage in serious policy discussions with the government. This builds on a major success of current Mission programs.

Efforts to address subtarget 1b, Expand Support Services for Exporters, include:

1/ Direct assistance to the private sector, in the form of firm-level assistance and targeted financing programs that will maximize the "supply response" to both of the transitions, thus both directly enhancing economic growth and reinforcing GOK commitment to the policy reforms involved. This assistance would grow out of the lessons learned from the Mission's recent activities.

2/ Institutional support to private sector organizations to enhance their capacity to provide direct support to Kenyan businesses, as mentioned in item 3 above.

Efforts to address subtarget 2a, Improve the Regulatory Environment and Support Services for Small and Medium Enterprises, consist of institutional development and direct service provision to and through private sector organizations who represent the various components of the private enterprise community.

More specific detail on project interventions and a table illustrating allocation of resources by type of activity to date are contained in Annex C. A description of subsectoral issues (privatization, women in development, agribusiness, and microenterprise) interwoven into the Mission's new private enterprise strategy and proposed interventions is contained in Annex G.

III.C. Indicators

Strategic Objective:

In 1989 the formal private sector created fewer than 50,000 new jobs, while approximately 400,000 young Kenyans had entered the workforce. By 1995 the aim is to create at least 337,500 new jobs in the non-farm private sector with no reduction in real wage rates.

To measure performance in increasing non-farm private sector labor absorption at constant or rising wages, USAID will calculate the real wage bill and measure the trend in real wages over time. Non-farm employment growth, disaggregated by agribusiness, manufacturing, services, public sector and parastatal elements, will be monitored, along with the change in the gap between labor force growth and employment generation.

Target 1: Increase Non-traditional Exports

The indicators for measuring attainment are:

* Export earnings from non-traditional exports (value added from EPZs, manufactured exports, horticulture, agroprocessed goods, and handicrafts) increased, in nominal dollar terms over 1990 figure, by 25 percent by the end of FY 1993 and increased by 50 percent by the end of FY 1995.

Subtarget 1a: Improve the Policy Environment for Exports

* Increase investment in non-traditional export enterprises.

  (Baseline study to be conducted in FY 91 to determine the level of investment in non-traditional export enterprises.)

Subtarget 1b: Expand Support Services for Exporters

* Increase by 150 the number of non-traditional export enterprises by the end of FY 1995.

  (As of 1989, there are 400 registered enteprises involved in non-traditional export operations. The range of services, adequacy of services and institutional development of the organizations providing such services will be measured at the project output level.)

Target 2: Increase the Profitability of Small and Medium Enterprises.

* Increase the number of SME new business starts each year.

  (Central Bureau of Statistics and Stati ical Abstract data will be cross checked with business association registries to create baseline data for small and medium enterprise creation and devise parameters for monitoring of progress. Current GOK data collection does not disaggregate new business starts by size of business, hence further analysis by the Mission is indicated.)

Subtarget 2a: Improve Regulatory Environment and Support Services for Small and Medium Enterprises.

* Increase the amount of investment in SMEs.

  (Baseline study to be conducted in FY 91 to determine investment levels in SME's.)

ANNEX A

Summary of the 1985 Strategy

OBJECTIVES:

The overall objective of USAID/Kenya's strategy in 1985 was to assist the GOK in its efforts to promote sustainable growth of the economy through private enterprise. Implicit in this overall goal were two specific objectives that were the keys to USAID/Kenya's 1985 private sector strategy: (1) seeking to overcome the constraints that are a natural result of Kenya's current economic status - a small domestic market, inadequacies of local inputs, lack of managerial and entrepreneurial skills, incomplete adaptation of technology and shortages of investment finance, and (2) continuing to support the Structural Adjustment dialogue between A.I.D, the World Bank, IMF and the GOK, aimed at moving government policy away from the promotion of large capital-intensive industries concentrated in import substitution to a more market oriented approach.

AREAS OF ASSISTANCE:

The 1985 strategy directed its current and planned project and program assistance to six specific areas: 1) finance, 2) management and entrepreneurship, 3) technology and technical skills, 4) the informal sector, 5) exports and 6) investment promotion. The first three target areas sought to address constraints to growth while the last three were directed at high potential sectors. Most of the areas also involved one or more important policy issues.

In finance the Mission proposed to supply term credit to small and medium sized firms through the Rural Private Enterprise project. It would also assist commercial lenders by creating one or more discount facilities that would give lenders wider discretion in selecting borrowers and include agricultural loans as well. The Mission also planned to develop a loan guarantee fund to help ease collateral requirements for smaller firms and to work towards the creation of a venture capital fund or other source of equity capital.

In managerial and entrepreneurial skills, outside the private enterprise portfolio, the Mission developed the Agricultural Management Project to supply in-house training and technical assistance to firms in agriculture and related industries. It also planned to institute the Training for Development Project in 1986 which would provide specialized training for selected individuals many of whom would work in the private sector. Finally, in order to develop stronger entrepreneurial attitudes, an entrepreneurial development component was also targeted.

In technology and technical skills, the strategy planned for direct transfer of technology through the consulting services of the International Executive Service Corps (IESC) and possibly to give support to some of the local technical institutions.

In exports, the strategy suggested a major new initiative that would cover the areas of export promotion, export finance and government policy towards exports. This new initiative would focus mainly on agribusiness and manufacturers. The Mission decided not to move forward with export promotion due to lack of appropriate private sector institutions through which USAID technical assistance could be channeled and a policy environment not conducive to export promotion at that particular time.

In investment promotion, the plan was to support the activities of an Investment Advisory and Promotion Center (IAPC), and other government or private investment groups. The strategy identified possible areas for IAPC activity such as improvements in the legislation affecting new investments, streamlining the investments approval process, and provision of industry-specific information for investors.

In the informal sector, besides the already existing program to PVOs assisting the informal sector, further developments were to include a search for ways to give informal sector firms greater access to credit, either creating links to formal credit institutions or by encouraging institutions such as savings and credit societies to work more effectively with the informal sector.

The target group for the 1985 strategy included any privately undertaken activity that was intended to generate enough income to make a profit or to sustain itself. The mission was (and still is) strongly committed to providing assistance through the private sector whenever possible. Use of private enterprise was to guide the activities in all areas of the USAID/Kenya program in order to provide triple benefits to the economy of Kenya: improve service delivery, relieve burdens on government, and develop individual enterprises.

ANNEX B

Monitoring and Evaluation of Impact

The Private Enterprise Division will develop and track indicators of program performance relying primarily on the financial and personnel resources available through projects. Basic criteria for the overall monitoring and evaluation system include using existing information sources as much as possible, keeping program impact indicators as simple as possible, and relying on project mechanisms to collect and analyze most performance information which is not available from national statistics. These criteria address the need to utilize the most efficient and effective methods in view of the declining OE and USDH levels to provide collected, compiled and analyzed data on which Mission management can make program decisions.

At the Mission sub-goal level, the majority of the key indicators of private sector performance can be derived from regularly published GOK statistics. Change in total real output, wage and total employment, and net foreign exchange earnings, available from the GOK Central Bureau of Statistics and the Treasury, will be utilized to evaluate progress at the sub-goal level.

At the strategic objective level, two sources will be required to measure change in private enterprise employment and wages. For the formal sector, the GOK Annual Economic Survey, with an adjustment for USAID's estimate of the inflation rate, will provide the necessary data. Due to the absence of recent data on the informal sector, a survey is planned for FY 91 to establish a baseline on the number of employees and real wages of this sector. The survey will define the informal sector proportion of wage employment. Anticipated as a rapid appraisal survey conducted by a competitively procured, project-funded Kenyan firm, the study of the informal sector will form a proxy indicator of the sector. This approach is necessary given the informal entrepreneurs' reticence to report wages or income, and the lack of national statistics. While change in the level of employment and real wage bill of the formal private sector can be tracked on an annual basis, that of the informal sector will be monitored against the FY 91 baseline by special surveys to be conducted in FY 93 and FY 95.

At the level of program targets and subtargets, most program performance indicators will be based on project impact and output data which will be available from existing or planned reports from the implementing agencies. The GOK Annual Economic Survey can be utilized to track the target of increases in non-traditional exports -- measuring increased export earnings for other than coffee, tea and petroleum products. Information from the implementing agencies will provide data on the subtargets by monitoring increased investment in non-traditional export enterprises as well as an increase in the number of firms in this category. Parallel data will be obtained for the target and subtarget for SMEs; however, in addition to both national statistics and project-level data, special studies will be required. These studies will examine the structure of license fees to differentiate small and medium enterprises among the newly licensing firms and to determine, in addition to project generated data, the increase in investment in SMEs. As with the informal sector survey, a Kenyan consulting firm will be competitively procured using project funding to design, conduct and analyze the research.

An inventory of private sector policy reforms needed for an outward-looking, labor absorbing economy will be used as a checklist to assist Mission management with the ongoing policy dialogue with the GOK and for the program sub-goal, strategic objective and target levels. This list will include policy reforms acknowledged by the GOK as necessary for the enabling environment as well as those identified by donors or through pogram funded policy studies. Additionally, the inventory will include a listing of government regulations that have been rescinded to enhance private enterprise development. The inventory will be updated semi-annually to record the reforms approved and actually implemented. A management review of the status of the private sector policy reform inventory will be made part of the Mission's semi-annual implementation review.

At the project level, three approaches are required for monitoring the impact of: 1) firm-level assistance by NGOs, 2) credit programs administered by commercial finance institutions, and 3) the institutional development of local NGOs implementing the firm-level assistance components.

The NGO implementing agencies are collecting baseline data on the type of firm, ethenicity of owners, rural or urban location, number of employees (gender disagregated), level of investment, annual gross sales and percentage of sales exported. The implementing agencies then evaluate their activities, reporting changes in employment, investment, sales and exports as a result of the project intervention. The NGOs are also encouraged to report changes in knowledge, business practices and attitudes of clients in mini case studies to provide qualitative as well as quantitative data. The reports from the NGOs are consolidated for the semi-annual PIRs. Further, the baseline data on firms assisted is entered into a DBase program, which the Mission maintains, from which program level statistics on WID, microenterprise, rural-urban mix of clients, indigenous or female-ownership can be generated.

The commercial finance institutions administering credit programs do not collect and report similar impact data of changes in employment, sales, investment or exports on their borrowers. Consequently, rapid impact assessments will be contracted to Kenyan consultancy firms to monitor the impact of credit programs. Additionally, special studies have been and will continue to be conducted to monitor changes in the intermediate finance institutions lending practices, particularly in medium and long-term lending.

Sustainability of the local non-governmental organizations implementing firm level assistance components is crucial to the long-term impact of the program. Consequently, project managers will monitor improvements in prospects for both technical and financial self-sustainability of the NGOs as well as routine tracking of changes in services provided to clients, improvements in the efficiency of delivering quality services to an increasing number of clients, and increased client willingness to cost share for services.

ANNEX C

Portfolio Profile

The USAID/Kenya private enterprise program includes over twenty separate activities with total funding in excess of $122 million (see Table 1). Significant efforts are underway in three general functional areas: policy dialogue and investment promotion, financial and equity markets development, and management and entrepreneurial assistance and training. Certain projects will come to an end and new initiatives are planned to begin during the 1990-95 period covered by the revised strategy. Major components of the portfolio are:

1) <u>The Rural Private Enterprise Project</u> (1983-91)

* medium term credit for medium and large scale enterprises through commercial banks
* technical assistance to the Central Bank and commercial banks
* a revolving fund for future term credit
* credit for rural microenterprises
* technical assistance and training for NGO's which extend credit
* strengthening of an umbrella NGO to provide leadership, offer training and other services on a fee for service basis and conduct sectoral research.

2) <u>The Private Enterprise Development Project</u> (1987-94)

* a credit line for venture capital investments
* a management contract for a venture capital company
* investment promotion assistance and institutional strengthening of the Investment Promotion Centre
* assistance to the Kenya Association of Manufacturers for policy analysis, advocacy and training
* institutional strengthening of the Kenya National Chamber of Commerce and Industry, and the Kenya agribusiness trade association

* Micro-enterprise credit, technical assistance and training through WEREP, with an emphasis on the minimalist credit approach

* small business counselling and training through KMAP

* privatization of state-owned enterprises through restructuring of development finance institutions and public offering of their assets

* technology transfer, information searches and joint venture assistance through the International Executive Service Corps

* participant training through Entrepreneurs International.

3) <u>The Kenya Export Development Support Project</u> (1991-98)

* technical assistance and training for the GOK and private sector support institutions to develop and implement streamlined procedures

* support for the Export Processing Zone Authority

* establishment of a Trade Policy Analysis Unit in the Ministry of Finance

* pre-shipment finance or guarantees for exporters

* foreign exchange/KShilling swap arrangement for domestic investment in the EPZ's

* firm level assistance for exporters

In addition to the two major projects which will be active during the strategy period, there will be operational support for the Capital Markets Authority through the Structural Adjustment Assistance Program, and some loan guarantees and technical assistance support to finance institutions through the APRE Revolving Fund. From the Commodity Import Program local currency generations we will continue to support: enterprise restructuring through institutional support for the Rehabilitation Advisory Services; commercial bank credit for informal sector enterprises; and commercial credit for small and medium enterprises through DFCK.

In addition to those activities directly managed by the Private Enterprise Division, the Mission has other projects that involve the private sector. These include:

1) **Human Resource Development Assistance (1988-1985)**

* supports national and regional training programs that provide training to technical, scientific and managerial personnel, policy planners and business executives.

* the programs include technical training, seminars, workshops and special courses; training is divided evenly between the public and the private sector with a special emphasis placed on seeking out qualified women for training, especially in management areas.

2) **Training for Development (1987-1994)**

* potential leaders from both the public and private sectors are chosen for both long and short term specialized training the United States.

* a total of 64 Kenyans (39 from the public sector and 25 from the private sector) have been trained to date, 24 have been women.

3) **Agricultural Management Project (1985-1991)**

* project aims to improve the management and performance of private and public organizations which support agricultrual production.

* supplies in-house training and technical assistance to firms in agriculture and related industries.

4) **Kenya Market Development Program (1990-1994)**

* Provides balance of payments support, technical assistance, commodities and training to support the following policy changes:

* the removal of maovement controls on various agricultrual products.

* regular public announcements of market price and regulation information via the print and braodcast media.

* a 10% annual increase in the non-personnel portion of the operations and maintenance budget of the Ministry of Public Works/Roads Maintenance Branch.

The Mission also supports other activities focusing on the private provision of social services such as the Health Care Financing Program, Contraceptive Retail Sales, and private low cost housing finance schemes.

TABLE 1

PRIVATE ENTERPRISE PROGRAM FUNDING $

Rural Private Enterprise project (615-0220)		
Kenya Commercial Bank	12,000,000	
Barclays Bank	8,000,000	
Standard Chartered Bank	4,000,000	
Rural Enterprise Program	7,076,700	
Deloitte & Touche contract	3,791,402	
Other	1,131,898	
Sub-Total		36,000,000
Private Enterprise Development project (615-0238)		
Investment Promotion Center	2,714,000	
Kenya Association of Manufacturers	713,600	
Standard Chartered Trust	7,125,500	
Kenya Equity Management	2,275,817	
Rural Enterprise Program	5,841,469	
Kenya Management Assistance Program	560,238	
International Executive Service Corps	1,728,000	
Kenya National Chamber of Commerce	327,220	
Other	3,724,156	
Sub-Total		25,000,000
Private Sector Commodity Import Program		
(615-0213)	31,500,000	
(615-0240)	14,500,000	
Sub-Total		46,000,000
Capital Markets Authority (615-0240)		600,000
Private Sector Local Currency Program		
Kenya Commercial Bank FX	3,000,000	
Development Finance Corporation Kenya	2,000,000	
Jua Kali Loan	3,000,000	
Rehabilitation Advisory Services	750,000	
College of Insurance	1,250,000	
Unprogrammed	5,000,000	
Sub-Total		15,000,000
Total		122,600,000

ANNEX D

Management Burden

The private enterprise portfolio is managed by the Private Enterprise Division (PED) of the Office of Projects. The Private Enterprise Division is staffed with two U.S. Direct Hire employees, three U.S. Personal Services Contractors, and two Kenyan professionals. Both of PED's Kenyan professional staff members are U.S. trained MBA's. One has extensive experience in finance and microenterprise and the second focuses on policy issues and trade associations. Given the greater strategic emphasis on private enterprise policy reform in our program for the future, a PSC policy advisor has recently been recruited from the U.S. and has joined the PED staff. The Division's support staff of two are both trained in computer software to enable them to maintain the monitoring and evaluation system, in addition to providing normal secretarial support and keeping a current private sector resource library.

Over the past year significant progress has been made in delegating responsibility for implementation and evaluation to project contractors and implementing institutions. With several years experience working with private sector counterpart organizations, the Mission has developed good communication channels, a high level of understanding among them of USAID regulations and procedures for use of USG funding, and a sense of the varied strengths and capabilities of each of the organizations with which we work. Based on this, PED project managers have restructured implementation arrangements, in consultation with the Mission Legal and Controller's Offices, to delegate certain contracting and procurement authorities more fully to the implementing institutions. This has reduced the labor-intensity of the portfolio and contributed positively to the institutional development of the counterparts.

Following the recommendations of a Private Enterprise Program Evaluation, the Management and Evaluation database was redesigned to reduce extraneous data collection and simplify the data collection questionnaires to make them more "user friendly" for the implementing institutions. The onus of baseline and impact data collection has now been transferred to the grantees and contractors, with USAID only contracting for case study development and special impact evaluations.

The Rural Private Enterprise Program will end in March of 1991, leaving only the Private Enterprise Development Project, which is well underway. The Kenya Export Development Support

Program will be a new start to come on stream in late FY 91. KEDS management will largely be undertaken by contractors and Kenyan private sector institutions. The number of management units, therefore, will remain constant at two projects over the planning period.

Recent recruitment in the APRE Bureau in Washington has enhanced their capability to actively manage the APRE Revolving Fund activities in Kenya, thus reducing the amount of Mission staff time spent on these loan guarantees.

ANNEX E

Detailed Description and Chart of Donor Involvement in Private Enterprise Development in Kenya

The GOK has worked very closely with both the IMF and the World Bank during the last decade. It has had a series of seven stand-by arrangements from the IMF in support of economic stabilization efforts and has, at the same time, entered into five structural adjustment lending agreements with the Bank. These efforts have paid off as Kenya has avoided the sharp external and domestic disequilibria that have plagued many African nations. The latest IMF arrangement is an Enhanced Structural Adjustment Facility (ESAF) of SDR 240 million ($300 million), disbursing SDR 80 million ($100 million) in 1989.

Other IBRD and Donor Programs

In addition to the export sector assistance credit soon to be signed by the World Bank with the Government of Kenya, the World Bank has three other credits underway which are focused on trade liberalization and economic restructuring. The Financial Sector Adjustment Credit (FSAC) of $120 million supports policy change with regard to interest rate deregulation, import liberalization, generalized monetary policy instruments, and capital markets development. The African Development Bank (ADB), the Netherlands and USAID (under our Structural Adjustment Program) co-finance about $70 million of the FSAC.

The FSAC was designed to complement the Industrial Sector Adjustment Credit (ISAC), a $112 million credit intended to stimulate investment, export production and improve the efficiency of the sector. Co-financing for ISAC totals about $90 million, primarily from the OECF of Japan, the ADB and the European Investment Bank. As with the FSAC, the ISAC is an important component of the policy framework supporting the IMF's Enhanced Structural Adjustment Facility.

The World Bank has recently signed an additional credit with the GOK which will provide $6 million in technical assistance and training to restructure the assets and management of two of the country's development finance institutions. This is expected to contribute significantly to privatization of state-owned industries and future improvement in the quality and productivity of public investment.

The major portion of UNDP's $47 million Kenya portfolio is allocated to private enterprise development. Project implementation is carried out primarily through UNIDO and the ILO, with major activities consisting of policy formulation, entrepreneurial training, technology transfer to small enterprises, and establishment of a credit reference bureau and a research foundation for small enterprise. New initiatives are expected in quality control and small to large business linkages.

The Germans, primarily through the GTZ, have an approximately $15 million private enterprise program in place aimed at micro and small entrepreneurs. Belgium has almost $2 million devoted to informal sector activities. The Norwegians plan to program $5 million for small enterprise development, with a focus on credit and training for formal, rural enterprises. The Dutch are providing management assistance, credit and equity, and plan greater involvement in export promotion, policy reform, and innovations in small enterprise. The Commonwealth Development Corporation (U.K.) has allocated eight percent of its funding (roughly $8 million) to private sector activities--capital investments for industry and agro-processing. The CDC plans to increase the private sector share of its portfolio to twenty-five percent of total funding to Kenya over the next five years.

In addition to the World Bank and USAID, the donors most involved in export promotion activities are the Japanese, the African Development Bank and the EEC. The Japanese Government has pledged $660,000 of support for development of an Export Master Plan. A team drawn from the Japanese International Cooperation Agency (JICA), the Japanese External Trade Organization (JETRO), private industry and several domestic government ministries will work with the GOK Ministry of Commerce on commodity specific analyses of export potential and production expansion and marketing strategies. The Japanese may also co-finance the World Bank's export credit and participate in infrastructure lending for the EPZ's themselves.

The African Development Bank is following on the A.I.D-financed feasibility study for export processing zone development in Kenya, and the World Bank financed study of the Athi River EPZ, with a feasibility study for a zone in the Mombasa coastal area. The ADB may then proceed with financing for development of the Mombasa EPZ. Finally, the EEC has supported the Kenya External Trade Authority for the last ten years to enable this parastatal trade promotion body to participate in European trade fairs. They have indicated a willingness to become more involved in export development activities in Kenya, particularly in linkages with EEC markets, if the GOK demonstrates a greater private sector approach to export promotion.

The World Bank has initiated the policy dialogue with the Government of Kenya on export sector issues. The policy agendas being developed by USAID and the World Bank have been closely coordinated and complement each other well. The World Bank has also expressed interest in firm level assistance to exporters, and may bridge fund activities in this area until KEDS funding is in place. Several other donors are poised to pledge additional support to the sector based on the GOK's performance under the World Bank and USAID programs. A donor coordination group will be established to discuss export development activities among other private enterprise issues, and will provide a forum to update donors on the progress of ongoing programs and rationalize new resources to be provided for the export subsector.

DONOR ACTIVITIES IN THE PRIVATE SECTOR

	Policy Reform	Micro and SSE	Export Promotion	Other
USAID	FSAC; IPC, KAM Policy	Credit; Management and Entrepreneurial Training; PVO Cofi.	Future Assistance	Capital Markets; Term Credit; Equity Financing
World Bank	FSAC ($120M) ISAC ($112M)	Credit for TA and Training ($6M)	Future Assistance	CMA
ADB	FSAC; ISAC		EPZ Feasibility Study	
Japan	ISAC		Future Assist.	
UNDP ($40M)		Credit Reference Bureau Research Foundation; Entrepreneurial Training; Technology Transfer		Quality Control, Business Linkage, (UNIDO)
Germany ($15M)		Credit (KIE)		
Belgians ($2M)		Credit (KIE)		
Holland	FSAC	Management Assistance, Credit ($1.4M)	Future Assistance	
U.K.	Enabling Environment ($2.7M)	Mombasa Jua Kali		Capital Investments for Industry and Agri-processing ($8M)
EEC			Future Assist.	

FSAC - Financial Sector Adjustment Credit
ISAC - Industrial Sector Adjustment Credit
CMA - Capital Markets Authority
KIE - Kenya Industrial Estates

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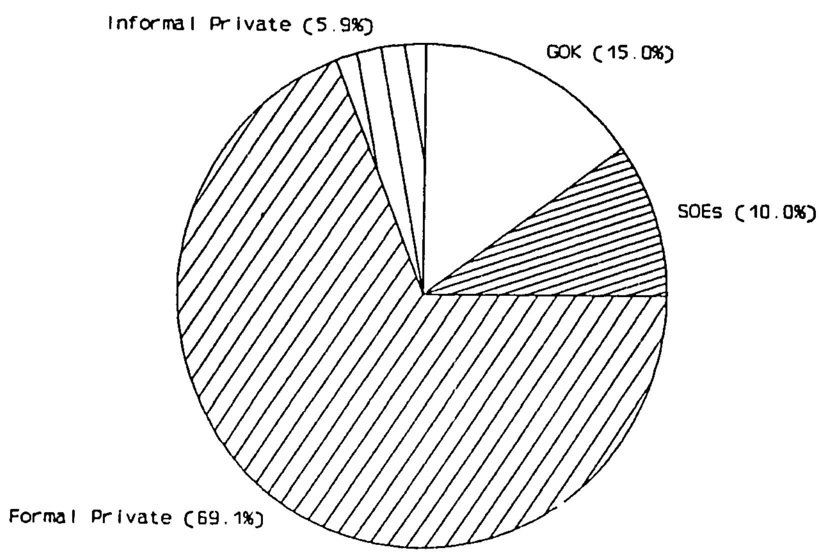
ANNEX F

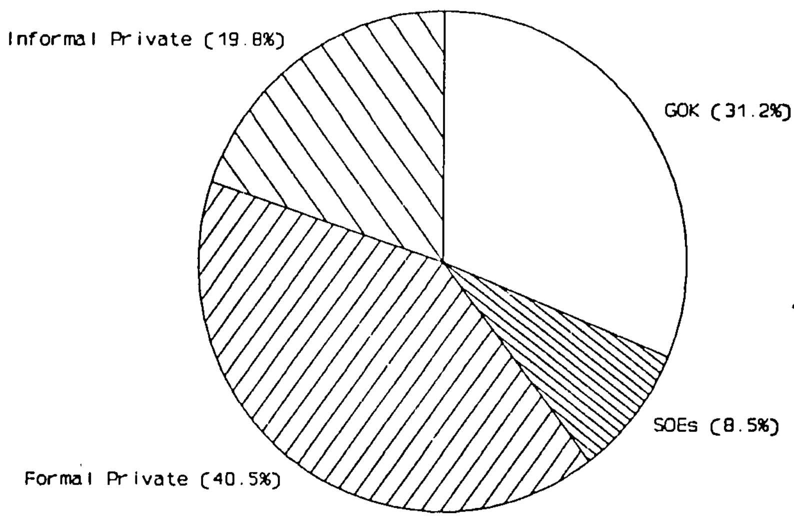
Description of the Productive Sector in Kenya

Kenya possesses a diverse and complex economy with productive enterprises roughly divided into three broad categories: parastatal (or state owned enterprises), informal private sector, and formal private sector. Parastatals are defined as enterprises with substantial, usually majority GOK ownership, either directly or through another parastatal. Informal enterprises are small (less than 5 employees) and are usually not registered or licensed. These definitions are not precise and the boundaries between categories are not always clear. There are degrees of parastatal ownership and degrees of informality, and these ambiguities limit the reliability of statistics concerning investment levels, employment and productivity. Nevertheless, in order to demonstrate general differences in performance, constraints and potential, such a categorization is appropriate.

Contribution to GDP



Contribution to Wage Employment



The Parastatal Sector

The Kenyan parastatal sector encompasses advisory, regulatory, production, marketing, and financial operations. Parastatals are involved in agricultural marketing, sugar factories, petroleum marketing and transport, rail and air transport, wholesale and retail trading, cement and textile production, financial institutions, housing, and tourism. Direct, 100 percent GOK ownership of productive enterprises is unusual. The usual mechanism is a partnership between a private investor and a parastatal development finance institution. The major development finance institutions in Kenya with equity in productive enterprises are the Industrial Development Bank, the Industrial and Commercial Development Corporation, the Development Finance Corporation of Kenya, the Kenya Tourist Development Company and the Agriculture Finance Corporation.

Parastatal involvement in the agricultural sector is far greater than would appear by its minuscule contribution to agricultural GDP (less than one percent in the official statistics). Parastatals are heavily involved in marketing, pricing, extension, credit, and even processing. The parastatals' record in the agricultural sector is increasingly weak; characterized by poor service delivery, late payments to farmers and almost nonexistent profits. Overall, the heavy role of parastatals has served to depress agricultural production.

Substantial gaps in statistics on parastatals, particularly for GDP contribution, hamper quantitative analysis. The gaps result from the lack of serious monitoring and auditing of parastatals until the State Corporation Act was enacted in 1986. Historical employment and fixed investment data for parastatals, however, are available through GOK surveys.

Parastatals' contribution to wage employment, 10 percent, has been relatively stable over the past 10 years. Parastatal fixed capital investment, on the other hand, has declined from about 25 percent of total fixed capital investment to less than 20 percent in the same period, reflecting the squeeze on public investment levels generated by the growing proportion of the budget taken up by the wage bill.

Although the parastatal sector has contributed only 10 percent of GDP and 10 percent of wage employment, it has absorbed a disproportionate 20-25 percent of annual fixed capital investment over the past 10 years. Clearly, parastatals are not efficient generators of jobs or profits.

The Informal Sector

Reliable information about the efficiency of informal sector enterprises is not available. Enterprises in the informal sector can be characterized, however, by very small size, high ratio of labor to capital, use of simple technology, and a lack of access to the formal business support system, including financial institutions.

Estimates of the amount of employment and product generated by the informal sector vary over a wide range, depending on definitions and survey methods. Officially, the informal sector contributes only 6 percent of GDP and 20 percent of wage employment. Both of these figures are probably underestimations. **Even so, according to the official statistics, the informal sector's contribution to wage employment has doubled since 1980.**

The growth in the informal sector has been largely fuelled by the policy and bureaucratic constraints on formal private sector job creation and competition, creating strong incentives for informality. It is clear that the informal sector is an employer of last resort, albeit at very low wages, to the growing number of Kenyans unable to support themselves in agriculture. Counting non-wage and on-farm employment, the informal sector accounts for over 80 percent of the workforce.

Informal activities exist in a wide range of subsectors, including manufacturing, transport, and trading. All informal subsectors have grown, but it is the trading subsector that has contributed most of the growth in informal employment. Relative to the formal sector, the manufacturing and repair informal subsectors produce lower quality, lower cost goods for poorer consumers, accepting smaller margins. These informal goods and services substitute for the higher priced goods provided by the formal sector.

Informal sector growth will likely stagnate, as the barriers to formal enterprise growth are removed, and imports are more accessible and reasonably priced. Despite its many shortcomings, however, the informal sector has been an important seedbed for entrepreneurial development in Kenya as well as a source of technological adaptation at the simplest levels.

The Formal Private Sector

Virtually all formal private sector expansion in the first decade after Independence was financed by foreign investment. At first, this was capital transferred out of local agriculture, but quickly, multinationals joined the rush. By the late 1970's, foreign involvement in the formal economy was extensive ($500 million from the U.K., $200 million from the U.S., $60 million from Germany, and another $100 million from Switzerland, France, India, Italy, and Japan). The scope of the roughly 350 multinationals that were active at the time included banking, engineering, tourism, oil refining, and various manufacturing activities.

Data on the ownership of businesses is sparse after the 1970's. Nonetheless, it is clear that the role of foreign private investment has decreased significantly in the past ten years. Parastatal and multilateral finance capital on the other hand has become much more important. In fact, real foreign capital deployed in Kenya has shrunk, mostly through passive disinvestment (i.e., by not replacing depreciated capital) and in some cases active disinvestment, especially by U.S. firms (Firestone, Mobil). Also, the decline of foreign investment has increased the relative role that Asian entrepreneurs play in the Kenyan economy, despite the existence of discriminatory practices against them.

The formal private sector officially contributes 69 percent of GDP, 40 percent of wage employment, and absorbs 60 percent of fixed capital investment. Thus, it is a fairly efficient generator of output per investment, but a much less efficient generator of jobs. In fact, the formal sector's contribution to wage employment has decreased significantly since the early seventies; from 50 to 40 percent, concomitant with the rise of informal sector employment. The formal sector share of output has shown little change in the past 10 years.

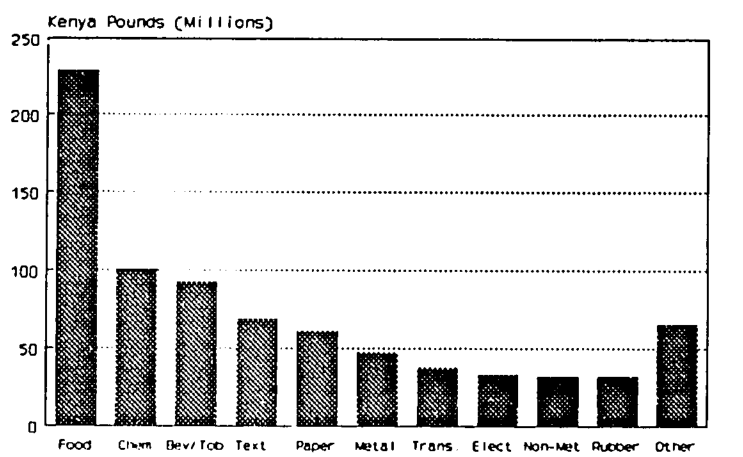
In the following sections, we discuss in more detail manufacturing, agriculture, and services, which amongst them contribute over 90 percent of formal GDP.

Manufacturing

Manufacturing contributes about 14 percent of GDP. Growth in manufacturing slowed from 10.5 percent annually between 1965 to 1980, to 4.6 percent annually between 1980 and 1988. Even more dramatically, real earnings in manufacturing have dropped off more sharply, from an index of 120 in 1973 to 75 in 1985. This has contributed to the sluggish growth in domestic demand. The relative stagnation of the industrial sector can be attributed to increased government regulation, restricted access to inputs and markets, as well as deteriorating demand in regional markets. Sluggish growth in this sector should be seen in context; Kenya's performance is well above the sub-Saharan average -- which is close to zero growth.

Food processing (milling, meat/dairy, sugar, other) is by far the largest component of manufacturing, both in output and value added; chemicals are slightly more than half of food in terms of output, but less than half in terms of value added. Industry is concentrated in Nairobi (50 percent), Mombasa (20 percent), and to a lesser degree in Nakuru, Eldoret, and Kisumu.

Private Sector Manufacturing
(Gross Product 1988)



Foreign capital and capitalists were very active in building up the industrial sector after Independence, which grew rapidly until the collapse of the East African Community in the mid-seventies. As late as the early 1980's, multinationals owned or controlled nearly 50 percent of the industrial sector.

Both foreign and GOK industrial investment was and is heavily weighted towards simple import substitution (food processing, auto assembly, chemicals, cigarettes, clothing, metal products, paints, paper, printing, soft drinks, textiles, and tire production). These industries, although financially profitable under massive protection, often have little value added. In fact, some assembly operations (automobiles, e.g.), produce at negative value added and cost the country more foreign exchange than simply importing finished goods. The manufacturing sector, as a whole, is a net user of foreign exchange.

Linkages between the large scale manufacturing sector and the rest of the domestic economy are not highly developed. Downstream products are expensive because of monopoly/oligopoly situations and protection; upstream, the manufacturers tend to rely on imported raw material and intermediate goods.

Asians, who dominated commerce and already had substantial manufacturing investments at Independence, were unofficially discouraged from entering manufacturing. In the early seventies Asians held only 35 percent of manufacturing assets. In recent years, however, Asian partnerships with prominent politicians in industry have replaced, in part, the role of foreign capital, and to a lesser extent, the emergent Kikuyu elite of the Kenyatta era.

Initial plans to Africanize industry through pressuring large foreign companies to go public backfired; most of the shares eventually came to be held by Asians. Two notable exceptions are the ICDC Investment Trust, created for citizens to own shares in parastatal and new businesses, and Kenya Breweries. Both are widely held by Kenyan Africans (although mostly Kikuyu). Much of the African equity in manufacturing is in relatively small enterprises. Larger enterprises often co-opt prominent Africans, who offer political protection in return for a share in the profits. Although larger firms (over 50 people) provide over 80 percent of manufacturing GDP, smaller firms are increasing their relative share.

The volume of manufactured **exports** has actually fallen since 1973. Outside of refined oil (to a captive regional market), portland cement, and canned pineapple, manufactured exports are largely low quality goods produced predominantly for the local (and regional) market.

Agriculture

Despite a gradual decline in importance since the mid-1970's, agriculture is still the single most important contributor to GDP, about 30 percent. Annual growth in agriculture was about 3 percent in the 1980-1988 period; compared to 5 percent in the 1965-1980 period. This slowdown is largely due to the secular decline in the prices of coffee and tea.

Coffee and tea alone contribute almost 15 percent of GDP, and over half of total export earnings. Cattle, maize, dairy, sugar, wheat, pyrethrum, and sisal are also significant contributors to GDP. The value of fresh horticulture produce and canned pineapple has been increasing over the past decade, and they are now the fourth largest foreign exchange earner. Because gross margins per acre in horticulture far exceed coffee or tea, it is likely that, where feasible, land will be converted away from these crops.

Commercial production is dominated by the 3700 large-scale farms (over 20 hectares) that are less vulnerable to the vagaries of the agricultural parastatals. Although nearly 30 percent of smallholdings also produce significant commercial crops, poor extension and marketing services have hampered their involvement. The more successful schemes involving commercial production by smallholders have been privately run (e.g. the East African Breweries barley outgrower system).

African ownership of farms has increased dramatically since Independence. Most of the white owned "mixed farms" have been sold for African occupation, at full market value. Cattle ranches, sisal, tea, and coffee estates were not part of the resettlement program; but even in these sectors (especially coffee) there is a large and growing African presence. Kenyan Africans have an insatiable "land hunger"; surpluses from African owned trading and agricultural enterprises tend to be used to acquire more farm land. Asian ownership of mixed and commercial farms has always been unimportant.

Availability of land and premises for horticulture, agro-industrial and manufacturing expansion, and for commercial enterprise establishment is increasingly a problem. The amount of arable land, given the burgeoning population, has declined on a per capita basis from nearly a hectare per capita at Independence in 1964, to just over a third of a hectare per capita today. Access to land is particularly limited for women who are proscribed by tradition from inheriting land. This poses problems not only in obtaining needed land for an enterprise, but also in accessing credit for investment since the most common security required for commercial lending is a land title.

The titling process itself is another constraint to investment in productive enterprises. Because of the scarcity of land overall and the sensitivity of tribal groups to tribal land passing out of tribal hands, the process of land sale and titling is extremely cumbersome and time-consuming. Even after the process of agreement to purchase, local tribal council assent, and all requisite paperwork is completed, there is such a backlog in the land registry office that finalization of the transaction can take an additional several years.

The large number of indigenous businesses, across a range of sizes, operating "informally" on land is attributable to the difficulty in legally accessing land and premises. Lack of access to land has also been cited as an obstacle to new investment -- both domestic and foreign -- in non traditional agricultural and agroindustry. Some relief is in sight with a recent Dutch aid pledge to assist in restructuring the land registry operation.

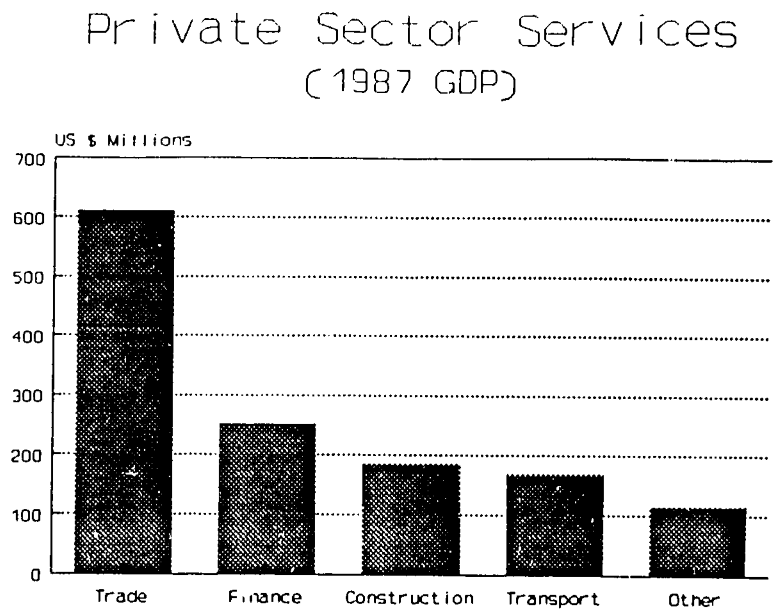
Services

Kenya's service sector provides over 30 percent of GDP and by far the largest share of wage employment (23 percent). In fact, growth in modern wage employment over the past ten years has been primarily from an expansion of the services sector. While the growth in the services sector has slowed from 6.4 percent in the 1965-1980 period to 5.5 percent in the 1980-1988 period, this decline in growth is relatively less than other sectors. Thus, the service sector share of GDP has actually increased.

Trade (including most of tourism, as well as retail and wholesale activities) accounts for nearly half of service GDP. Finance (19 percent), construction (18 percent), and transport (13 percent) are also significant. While parastatals play an important role in transport and finance, they are less prominent in trade, and their role is insignificant in construction.

Tourism, the most dynamic component of the services sector, is now the single largest foreign exchange earner, passing coffee for the first time in 1987. In real terms, however, gross receipts from tourism have grown only marginally since the late 1970's, despite an upturn in the number of visitors. In addition, the net foreign exchange earnings from tourism are probably far less important than the gross figures would indicate.

The services sector, particularly trade, has had significant African participation, because of low barriers to entry; nonetheless, African participants tend to be in low margin, low profit enterprises. Efforts were made to improve African traders' competitiveness by loans and restricting certain trading licenses to citizens; but this had little impact. A more successful Africanization strategy was started by the private sector in the sixties, the development of "satellite firms" -- agencies and distributorships -- around some of the major companies (Bata, BAT, Mitchell Cotts are a few examples). The parastatal Kenya National Trading Corporation duplicated this strategy with some success; it negotiated sole importer and distributorships, and then appointed African traders as agents. Nonetheless, the large firms that dominate most subsectors in services are still dominated by non-Africans.



Constraints to Private Sector Growth

Constraints to private sector growth flow primarily from three sources: adverse world-wide market conditions, GOK policy, and general constraints which are a function of Kenya's short history of modern development. As a result of these constraints, returns on private sector investment are depressed, risks are increased, and as a consequence private capital flows to less productive uses -- capital flight and real estate speculation. While hard data are not available, discussions with both foreign and domestic businessmen and financial analysts confirms the first, while a look at the ever-expanding Nairobi skyline confirms the second.

--Adverse Market Conditions

These constraints are largely outside the direct control of the GOK or the donor community, at least in the short and medium term. Nonetheless, they need to be kept in mind when examining strategic options. Adverse market condition constraints can be sub-divided into those having a current effect and those that may come into play in the near future. In the first category are:

> Commodity prices of key Kenyan exports, especially tea and coffee, are volatile and have declined in real terms.

> Regional markets purchasing power and access have decreased markedly because of inappropriate government policies, and commodity price declines.

In the longer term,

Market access to developed countries may shift from relatively free (except in certain horticultural produce) to constrained (especially in textiles and garments). Changes in the EEC access policies (through the Lome convention) and the composition of membership (more EEC member countries with low costs of production), in particular, may hurt Kenya's preferential access to its most important developed market.

Competition will come from a majority-ruled South Africa, with less restricted access to world markets. In regional markets, South African competition could overwhelm Kenya in the industrial sector.

--Government Policy and Controls

Policy problems in the following issue-areas have been a damper on private sector investment and growth over the past two decades. The GOK is attempting, to a greater or lesser extent, to address most of these constraints.

Credit. The scarcity of credit for the private sector is a function of 1/ the large share of the credit market absorbed by the public sector both by the GOK directly and by the parastatal sector (together about 40 percent) and 2/ IMF-mandated credit targets (i.e., growth of 1 percent a month) that are part of on-going stabilization efforts aimed at reducing inflationary pressures. In this context of scarcity, GOK mandated interest rate ceilings encourage banks to loan only to their best (lowest risk) customers, usually the GOK, parastatals, and established private sector firms. This is exacerbated by the limited recourse banks have to collect on bad debts under current Kenyan practices. As a result, entrepreneurial, high risk customers (especially new and small businesses) are squeezed out of the credit markets unless they raise 100 or even 200 percent collateral. Trade finance, working capital, and investment credits are difficult to obtain except for established bank customers.

Equity. Restrictive capital markets regulations make the cost of funds raised on the stock markets very high; it therefore provides an unattractive means of raising finance, or for a successful entrepreneur to "sell out". In addition, lax accounting and disclosure regulations and practices mean that the passive, minority investor has little insight, control, or protection against unscrupulous management/majority owners.

Foreign Exchange Restrictions on remittances of profits and other invisibles (resulting in delays of 12 to 24 months) discourage foreign investment. Domestically based firms find critical overseas marketing efforts crippled because of restricted foreign exchange available for business travel. In the past, foreign exchange shortages meant that imported raw materials were allocated by the GOK, which wreaked havoc on planning and profitability in the private sector.

Price Controls reduce the profitability of certain sectors, create an irresistible temptation to smuggle controlled items out to countries that pay higher prices, and generate a scarcity of inputs available to domestic businesses.

Import Restrictions, including punitive import duties, while protecting some domestic industries, force downstream producers to use low quality, high cost inputs. Thus, Kenyan industry is uncompetitive in overseas markets, and needs continued protection on domestic markets.

Parastatals, with GOK-granted subventions and monopoly powers, crowd out private sector access to markets and credit. The problems start at the top; unmotivated and incompetent management selected for political loyalty set the stage for high cost production, inefficient provision of services, and at times massive embezzlement.

Petty Corruption flows directly from administrative red tape; i.e., the many approvals and licenses required provide numerous opportunities for unofficial payments to unmotivated, underpaid civil servants. As a consequence, basic services are not performed in a timely and effective manner, or they are delivered for a bribe that must be passed on to consumers. In addition, well-intentioned policy directives from the top are not always implemented.

Influence Peddling is the euphemism used by the GOK for grander scale corruption. Successful businesses (and prospective investors) are often obliged to give involuntarily a share of the equity to prominent politicians; thus, there is a significant upside risk in becoming a visibly successful business in Kenya.

In summary, economic policy in Kenya is marked by a long-standing, if now largely discredited, philosophy of development which is suspicious of market forces. Market forces in Kenya have, in most instances, been superceded by pervasive government intervention. In addition to the policy orientation which protects import substituting industries and has provided real disincentives to growth of an outward oriented private sector, there is an overlay of government controls on every business transaction and activity which has the effect of increasing cost, decreasing competitiveness and slowing the response time to external opportunities.

The adverse business climate caused by the above constraints cumulatively result in a substantial anti-export bias in the economy. As a result, local businesses focus on the domestic market, which is limited in scope. Similarly, because exports are risky and less profitable, there is little incentive for the development of export support services (finance, brokering, market information, etc.). Thus, firms that could produce profitably for export under current conditions find that many of the critical support services available in export-oriented economies are not available in Kenya.

--<u>General Development Constraints</u>

Kenya's <u>human resources</u> endowment, particularly in the skill areas needed by the private sector (mid-level managers and skilled technicians), is very limited. This is exacerbated by a restrictive work permit policy for expatriates (compare the relative successes enjoyed by the Ivory Coast because of the contribution of French expatriates).

<u>Infrastructure</u> is poor relative to developed countries, and has been deteriorating in some areas. To make matters worse, maintenance of critical facilities is often given low priority by the GOK; instead, prestige construction projects are favored.

A <u>mercantilist</u>, rent-seeking approach to profits is pervasive, but it is a rational response to the highly regulated environment. Only slowly is this giving way to competitive, free-enterprise capitalism.

The problems of <u>governance</u>, in an ethnically diverse society, whose concept of nationhood is less than seventy years old and whose experience with modern state institutions is similarly limited, diverts an enormous amount of attention from serious analysis and implementation of economic development policies.

Finally, the continuing salience of traditional values has constrained expanded business development. The prestige value of land ownership among many Kenyans has meant that surplus capital has tended to be invested in acquiring agricultural land, rather than investing in other productive enterprise. Pressures from family and clan ties also divert individual's resources into redistribution rather than investment.

Opportunities for Private Sector Expansion

Despite the constraints that have been identified, there are real opportunities for private sector expansion in Kenya. These opportunities grow out of Kenya's obvious comparative advantages, which are:

- Low cost, trainable labor. There is an abundant supply of labor in Kenya. Minimum wage rates are about $40 per month for unskilled and $100 per month for skilled labor. This compares favorably with other African countries, especially those in the CFA zone, and very favorably with advanced developing countries in the Caribbean and Latin AMerica. Workers are considered highly trainable. Turnover and absenteeism are relatively low, workers have experience in an industrial setting, and generally have asimilated a modern work ethic. Productivity has been a problem, but recent trends are showing improvement.

- Regional Business Center for East Africa. Most international organizations, public or private, that need a regional office in East and Central Africa are in Nairobi. This is due to a combination of stability, international airline connections, good telecommunications and transport infrastructure, and excellent housing and social amenities. The tend has only increased with the deterioration of Khartoum, Mogadishu, Dar Es Salaam and Kampala, and to a lesser extent the other major cities in the regional As a consequence, goods and services are available in Nairobi that are not elsewhere in the region.

- Business and Entrepreneurial Orientation in Government, ruling party, business and general citizenry. Most Kenyans in and out of government have endorsed and have long been comfortable with business and the capitalistic ethic. Since Independence, business has been allowed to exist and grow with out major hindrance or nationalization, in distinct contrast to Tanzania and many other of Kenya's African neighbors. Even the 1965 Sessional Paper #10, "African

Socialism and its Application to Planning in Kenya", indicated the importance of private enterprise; many of its socialistic tenets have been honored largely in the breach.

- <u>Preferential Market Access to the EEC, North America, and the PTA region.</u> As one of the developing countries in the Africa, Caribbean, Pacific (ACP) region, Kenya has duty and quota free access under Lome IV to the EEC for most manufactured and agricultural goods. Kenya has GSP status with the United States, also insuring duty and quota free access for most goods. As a signatory of the Preferential Trade Agreement of East and Southern Africa (PTA), Kenyan produced goods enjoy a preferential duty treatment in the 20 member countries of the PTA.

- <u>Fertile land.</u> Kenyan agricultural land is among the most productive in the world, facilitating low cost production and flexibility in crop choice.

- <u>Temperate Climate.</u> A year round temperate climate means that two or more harvests of certain crops per year may be obtained. It also means that agricultural production can be timed for off-season demand in Europe and other Northern countries. Finally, it enhances tourism's appeal, and the attractiveness of Kenya as a place to live and do business.

Based on the above, the following export-oriented sectors have been identified to be particularly promising:

<u>Agribusiness</u>: Textiles are a good example of a high potential agribusiness; relatively low-tech, labor intensive, that takes advantage of quota-free, preferential access to the EEC and North American markets, and could capitalize on Kenya's potential to grow fiber inexpensively. Fruit processing (using the surplus output of the horticultural sector) is another very promising area. Already underway are canned and frozen exports of green beans to Europe to complement the large scale export of fresh green beans for the winter market, allow the farmers to sell year round production, and obtain for the processors the value added of agro-processed products. As another example of the potential for expansion in the agribusiness sector, negotiations are underway between a local agroprocessor and Heinz, on a joint venture for the domestic and regional markets.

<u>Fresh Horticulture</u>: Kenya's year round temperate climate, fertile soils, and adequate infrastructure enables profitable production of ordinary fruits and vegetables for the European off-season -- and year round production of tropical produce. Horticulture also capitalizes on the surplus of unskilled rural

labor, and increasingly, on forward linkages to agri-processing. The volume of fresh horticultural produce has nearly doubled in four years, form 31.3 million kilograms in 1984 to 59.1 million kgs in 1988.

Light Manufacturing: Garment production is a good example of labor intensive, low tech, light manufacturing that benefits from preferential access and backward linkages to textile and other agribusiness inputs. Kenya's location and strong history of trading make regional markets attractive as well.

Tourism: Kenya's superb plains wildlife and coastal beaches, excellent hotel facilities and well trained tourism workforce, underutilized national parks and reserves, and prestige brand-name image make tourism an attractive area for growth. Tourism is now the single largest producer of foreign exchange, earning Kenya $ 400 million in 1989.

Services: Although not yet a developed export sector, there is a great potential for the continued development of the services sector, particularly those oriented to the commercial and industrial sectors. If the GOK follows through on implementation of the right kinds of policies and incentives, the newly dynamic and profitable private sector will begin to demand locally provided high quality services.

ANNEX G

Special Interest Areas

Women in Development:

The USAID/Kenya Private Enterprise Strategy, with its focus on employment through expansion of non-traditional exports and small and medium enterprises, will have strong positive impact on the incomes of Kenyan women and the welfare of their families.

At present, Kenyan women comprise 22% of the total labor force. While on average 25% of the workforce in small and medium enterprises (SME) is women, the figure for large firms is only 11%. Generally, under Kenya's current industrial structure, the participation of women in the workforce decreases as the size of the enterprise increases. Women's representation in management decreases more dramatically as the size of firm increases -- 23% in SME's, but only 5% in large firms. The picture in export-related operations is mixed. Kenya's handicraft industry, which earned the country almost $8 million in foreign exchange in 1988, is currently dominated by women, who constitute 80% of the exporters. In horticulture, 17 women exporters controlled 10% of the market in 1988.

Currently our program is reaching 5,703 firms, of which 30% are women owned. While we do not provide the implementing agencies numerical targets for serving women clients, we encourage their increased outreach to women-owned firms, particularly by means of marketing their program activities through channels provided by professional and business women's groups. Additionally, through consciousness-raising training and continuing dialogue, we have had success in gaining increased advocacy for women's access to our program resources through the addition of women to Boards of Directors and/or professional staffs of the implementing agencies themselves. NGOs implementing the program are required to report on women-owned firms as percentage of clients served, women as a percentage of all persons trained, and gender-disaggregated data on employment generation.

The impact of our programs will be monitored through our M&E system and reported on in our Project Implementation Reports, our case study work, and the WID Action Plan updates. The Private Enterprise Division maintains one staff person as the WID coordinator for our program, representing the office on the Mission-wide WID Committee.

The emphasis on women in development within the target of increasing the profitability of small and medium enterprises will continue through this strategy period. However, the most dramatic growth in employment and incomes for women is expected to come through non-traditional export enterprise expansion. Global experience has shown that the types of industries most suited to export operation, particularly those likely to be established in the export processing zones, are those which obtain high value added from the labor component of production. Typical examples are garment manufacturing and electronic assembly operations. They are highly labor intensive industries which require only semi-skilled workers for the production line and which favor employment of women. As is the case in other countries which have launched EPZ's, the vast majority of the direct employment from the export processing zones is expected to be for female workers.

The indirect employment created from the export processing zones as well as the employment generated through export enterprise development in the macro-economy will also provide good employment opportunities for women. The impact of the change in female incomes resulting from this program is expected to be strongly seen in improvements in health and educational status for the families of the workers. This has been studied extensively and found to be the case in the Dominican Republic zones and elsewhere. USAID/Kenya plans to monitor the social impact of both the indirect and the direct employment generated through export enterprise development.

Privatization:

There are currently 176 parastatals in Kenya, involved in all sectors of the economy -- agriculture, manufacturing, retailing, finance and services. The GOK is increasingly concerned about the drain of parastatals on the recurrent budget. However, there is no consensus on the approach to solving this problem (the Ministry of Finance would prefer to see the ailing parastatals go out of business; the Ministry of Industry is more concerned to preserve investment and jobs and favors a more moderate approach.)

USAID has and will provide modest support where opportunities arise. An example is privatization training for officials from the Ministry of Finance, the Attorney General's chambers and the Office of the President. The Government of Kenya has recently signed a $6.1 million loan with the World Bank for restructuring of two development finance institutions which have investments in 90 parastatals representing an equity investment of over $3.3 million. As part of this program, USAID/Kenya is providing two long term advisors to the Ministry of Finance to develop the overall privatization implementation plan for the Government of Kenya and give particular attention to assets and liabilities management. Our continued work with the Capital Markets Authority provides the framework for divestiture of government holdings and the credibility to ensure good public uptake of privatized properties.

Microenterprise Development:

USAID/Kenya has been involved in microenterprise development activities for over a decade. As one of the first Missions to be included in studies and early credit components of the PISCES Project out of AID/W, an analytic base of credit and training needs and NGO capabilities was established in the early '80s. Stemming from this analysis, the Rural Private Enterprise Project was started in 1983 to provide support to an umbrella NGO which would be responsible for extension of credit, technical assistance, training and research results to other NGOs working on income generating activities. This was determined to be the most effective mechanism for reaching rural entrepreneurs and institutionalizing the capacity to sustain microenterprise lending. This umbrella NGO has worked with 32 NGO's, and 18 community groups and business associations, who together have extended credit to over 7300 people. Over 50 % of the beneficiaries have been women. This approach, while clearly the most feasible at the time of its design, has proven to be quite expensive to administer.

Given that the investment in institutional development of the NGO's (a large component of project costs) has largely taken hold, the program now is able to shift its focus to using the best of these NGO's to extend credit in more cost effective terms. The preliminary results of "Grameen Bank"-like minimalist credit schemes which have been started under our program, give every indication that this is the path the program at large should follow. The umbrella NGO has worked with their own governing board and the participating NGO's to introduce this new approach and obtain their concurrence to adopt it.

During this strategy period, the Mission's microenterprise credit programs will follow the minimalist model, with pilot programs in both group-guaranteed savings and lending schemes, and individual lending programs, to determine which approach is most efficacious. A heavy research component of the program will examine the elasticity of demand for credit at differentiated interest rates, calculate breakeven costs for program operations, and study in depth the impact of the credit programs on the enterprises, the sectors in which the enterprises operate, and the beneficiaries and their families. This research is being conducted jointly with AFR/MDI and the APRE Bureau GEMINI Project and should provide some of the most comprehensive information available on the impact of microenterprise credit programs.

The beneficiaries under this revised program will consist of those entrepreneurs in businesses with less than five employees, but also those small scale entrepreneurs who are part of larger collectives (women's groups, market enterprise committees, youth groups). In crossing the line from the strict definition of a microenterprise, and working with groups who can extend pooled credit to larger numbers of individuals, this approach will minimize cost and maximize impact on the target group. There will be more emphasis on the emerging small and medium enterprises than on the most rudimentary informal sector artisans, as from our analysis, this group has the most potential for growth and productive labor absorption.

The Mission may continue limited dedication of CIP-generated local currencies to an informal sector lending scheme, if agreement can be reached on the terms of lending and the ceilings on administrative cost. An evaluation of the pilot phase of this program showed that it cost approximately $1.70 for each $1.00 of credit extended. However, given the adminstrative costs of reaching threshold level entrepreneurs, the limited potential for their enterprises to grow and employ more people (the recent results of an ODA-sponsored twenty year retrospective study on over 1000 informals showed no conclusive growth of these enterprises or graduation to the larger scale formal sector operations), and the interest of other donors in programming in the sector, USAID will not program additional resources to the entry level informal sector enterprises.

The umbrella NGO and the groups with whom it works have established monitoring and evaluation systems to collect baseline information on each enterprise to be assisted and the impact of the assistance on gender dis-aggregated employment, sales, and assets. The data collection will also compile information on family status and use of additional income at the enterprise and household levels. The data collection which takes place at the implementing agency level is forwarded to the Mission and compiled in the private enterprise program database for inclusion in our microenterprise reporting to AID/W.

Agribusiness:

The private enterprise strategy of the Mission will continue the dynamic relationship between the agricultural programs sponsored by the Agriculture Office in the areas of market deregulation, agricultural research and education, and the demand driven services and enabling environment interventions funded under the private enterprise portfolio. The types of agribusiness assistance available under current and future private enterprise projects consist of general business management support and training (e.g. supervisory skills, accounting, packaging, marketing); limited technical assistance on specific crops or products on a fee for service basis and credit for agribusinesses while our current targeted credit program is still in operation. Due to a limit in our resources, the private enterprise program portfolio cannot address the supply side need for focused research and extension activities to expand and improve cash crop production. Market driven research and extension are essential to development of direct agro-exports, and for the needed inputs and the backward linkages for the agro-industrial sector which has been proven to have so much potential in Kenya. It is hoped that the agriculture portfolio can increasingly focus on a pro-active approach to specific export crop research and to outreach work for farmers -- bringing them the new technology and market access and enabling them to diversify production increasingly to include exportable cash crops.

Our current portfolio gives heavy emphasis to agribusiness. In technology transfer and management technical assistance provided through the International Executive Service Corps (IESC) grant, 23% to date have been in agroindustrial areas. The percentage of IESC consultancies in the horticultural and agroindustrial areas increased from 10% in FY 88 to 35% in FY 90, reflecting both increased client-driven demand and IESC-targeted marketing activities. A refocus of IESC activities will have this institution concentrate in future on providing consultants in the fields of export-oriented agroprocessing and horticulture.

Within the $24 million medium term lending program of the Rural Private Enterprise Project, 43, of the 73 projects to date, are in the agribusiness subsector. USAID support for the Agri-Energy Roundtable Kenya (AER/K) recognizes the need for a membership driven coalition based on linkages between agricultural production and industry in Kenya. AER/K has the potential to provide the agricultural and horticultural producers, the agroprocessors, and agroindustrialists the catalyst for policy reform and broad services similar to the role that the Kenya Association of Manufacturers has played for the general manufacturing sector. This trade association assistance is provided under the auspices of the private enterprise program and managed by the Division staff with close coordination with the Office of Agriculture.

Future work in non-traditional exports, envisioned under the Kenya Export Development Support Project, will provide technical assistance and institutional development support along with direct assistance to exporters themselves in the areas of horticulture and agro-industry.

There is close collaboration between the Private Enterprise Division and Office of Agriculture staffs on research, extension, agricultural management, agribusiness and trade association issues. This joint working arrangement will be strengthened during the strategy period.

ANNEX H
Acronym List

A.I.D.	Agency for International Development
ADB	African Development Bank
APRE	Asia and Private Enterprise Bureau
CDC	Commonwealth Development Corporation
CMA	Capital Markets Authority
CPSP	Country Program Strategic Plan
DFCK	Development Finance Company of Kenya
EEC	European Economic Community
EI	Entrepreneurs International
EPZ	Export Processing Zone
EPZA	Export Processing Zone Authority
ESAF	Enhanced Structural Adjustment Facility
FSAC	Financial Sector Adjustment Credit
FX	Foreign Exchange
GDP	Gross Domestic Product
GOK	Government of Kenya
GTZ	(German Technical Assistance Agency)
IAPC	Investment Advisory Promotion Center
ICDC	Industrial Commercial Development Corporation
IESC	International Executive Service Corps
ILO	International Labor Organization
IMF	International Monetary Fund
IPC	Investment Promotion Center
ISAC	Industrial Sector Adjustment Credit
JETRO	Japanese External Trade Organization
JICA	Japanese International Cooperation Agency
KAM	Kenya Association of Manufacturers
KATA	Kenya Agribusiness Trade Association
KEDS	Kenya Export Development Support
KETA	Kenya External Trade Authority
KIE	Kenya Industrial Estates
KMAP	Kenya Management Assistance Program
KNCCI	Kenya National Chamber of Commerce & Industry
MAPS	Manual for Action in Private Sector
NGOs	Non Governmental Organizations
PED	Private Enterprise Development
PTA	Preferential Trade Agreement
RAS	Rehabilitation Advisory Services
SMEs	Small & Medium Enterprises
SSEs	Small Scale Enterprises
UNDP	United Nations Development Program
UNIDO	United Nations Industrial Development Organization
USAID	United States Agency for International Development
USG	United States Government
VC	Venture Capital
WB	World Bank
WEREP	World Education Rural Enterprise Program

ANNEX I

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