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USAID/KENYA: PRIVATE SECTOR STRATEGY

CONCEPT PAPER

AUGUST 1990

CONCEPT PAPER FOR USAID/KENYA PRIVATE SECTOR STRATEGY

USAID/Kenya's private sector 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 sector portfolio in the 1980s, the priorities that have been set by the GoK, and the activities of other donors. This Concept Paper provides background to the Mission's strategy, 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 the conceptual overview and the strategic objective of the private sector program. The Concept Paper does not present the details of the objective tree for the private sector program, nor does it cover 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 countries outside of the CFA Zone, however, 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 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 appreciate 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

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 and successfully promoted small-holder agricultural production and facilitated the concommitant growth of off-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 delines 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, who have long-favored an alternative approach based on expanding the role of the private sector and increasing Kenya's competitiveness in international trade. In recent years, the costs of inward-looking and public sector led development have come to be focused on two key problems·

1/ limited employment-generation in the private sector of the economy leading to a rapid expansion of public employment, to declining real wages, and to the government becoming the employer of last resort for a whole class of highly-educated Kenyans with 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 that has 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 two 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. The underlying source of the employment problem, 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 various components of USAID/Kenya's programs all address elements of the labor absorption issue. Reducing the rate of population growth has long been the focal point of the Mission's population and health office activities. Recent data shows that the rate of population growth is beginning to slow, down from 4.1% in 1984 to 3.8% in 1989 The Mission's agriculture office strategy seeks to further 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, however, the absorptive capacity of the rural sector is limited and will be increasingly stretched

In many ways, the next two decades will be the most challenging in terms of the labor absorption problem. Table 1 illustrates the Ministry of Planning's projections for labor force growth in both urban and rural areas in the next twenty years. The projected urban labor force growth of over 7% 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 this expanding labor force has fallen on the rural economy, the informal sector, and increasingly, on the public sector In the 1974-1985 period, agricultural employment grew at nearly 7% per year and informal sector employment by 10% per year 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 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 in the real wages of public employees. Formal private sector real wages have also declined, although not as precipitously as those in the public sector. Evidence suggests that 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.

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 inexorably 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 spent 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, that are largely the result of the public-sector led employment strategy, are a major source of recent inflationary pressures in the economy, which now threaten the country's hard-won overall macro-economic stablity. The GoK is facing a scenario in which, unless job creation is successfully shifted to the private sector, <u>both</u> increasing unemployment <u>and</u> further lowered real wages are likely.

The reasons for the poor performance of the formal private sector in generating employment opportunities are clear The incentives in the formal sector have been distorted by quantitative restrictions, monopolistic licensing practices, and spreading corruption. The result has been capital flight, the shift of investment towards fixed 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

In response to these trends, 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 increasing effective demand in the domestic economy, reforming the regulatory environment to improve the efficiency of investment, and further integration with the international 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 was first enunciated in detail in Sessional Paper No 1 of 1986 and has been fleshed out in a series of documents, including the Sixth Development Plan, 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 government training institutions.

While an intellectual consensus has clearly been achieved on this issue, 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

I B The Balance-of-Payments Issue

Since 1985, Kenya has seen its foreign exchange reserves reduced substantially (from some $400 million to under $200 million) 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 Lower oil prices and rapidly increasing tourism receipts have substantially offset these trends, 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, 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 Annual imports, which represented slight less than one-quarter of GDP at independence have grown to 27% of GDP at present

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 improving the incentives for exporters.

Sessional Paper No 1 of 1986 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 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 drawback scheme, that are designed to improve the environment for exporting in the economy as a whole

Again, there is strong evidence of a clear intellectual consensus on the need for a transition from an inward- to an outward-orientation. But, as in the case of the transition in 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, both to promote greater efficiency in domestic-oriented production and to reduce the bias in the 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. Outside of increased horticulture exports, there has been little effect 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 the pressing need for increasing the economy's foreign exchange generating capacity

II. Description of the Private Sector In Kenya

Kenya possesses a diverse and complex economy. Productive enterprise ownership in the country can be roughly divided into three broad categories; parastatal, formal private sector, and informal private sector. The boundaries between these three categories are not always clear There are degrees of parastatal ownership and degrees of informality. Nevertheless, for the purpose of this analysis, such a categorization is appropriate.

II A. 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 GOK ownership 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 are the Industrial Development Bank, the Development Finance Corporation of Kenya, the Industrial and Commercial Development Corporation, the Kenya Tourist Development Company and the Agriculture Finance Corporation.

The parastatal sector currently contributes about 10 percent of GDP and 10 percent of wage employment, yet it has absorbed a disproportionate 20-25 percent of annual fixed capital investment over the past 10 years. Substantial gaps in statistics on parastatals, particularly for GDP, 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 Clearly, parastatals are not efficient generators of jobs or profits Parastatals' contribution over time 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 to less than 20 percent of total 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

II B. The Informal Sector

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 underestimates. In fact, the informal sector's contribution to wage employment has probably doubled since 1980. It is clear that the informal sector provides the first source of employment to the growing number of workers unable to support themselves in agriculture Counting non-wage and on-farm employment, the informal sector probably accounts for over 80 percent of the workforce.

Enterprises in the informal sector are characterized by very small size, labor intensity, the use of simple technology, and lack of access to the formal business support system, including financial institutions. The informal sector has been an important root source for entrepreneurial development in Kenya as well as a source of technological adaptation at the simplist levels 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 The manufacturing and repair informal subsectors contribute low-cost goods for poorer consumers that substitute for the higher priced goods in the formal market.

II C The Formal Sector

The formal private sector contributes 69 percent of GDP, 40 percent of wage employment, and absorbs 60 percent of fixed capital investment Thus, it is a relatively efficient generator of output, but not jobs. In fact, the formal sector's contribution to wage employment has decreased significantly since the early seventies; from 50 to 40 percent. The formal sector share of output has shown little change in the past 10 years

Virtually all formal private sector expansion in the first decade after independence derived from foreign investment. At first this was domestic capital transferred out of 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 a host of manufacturing activities

Data on the ownership of businesses is sparse after the 1970s. Nonetheless, it is clear that the role of foreign private investment has decreased significantly in the past ten years; parastatal and multilateral finance capital has become much more important In fact, real foreign capital deployed in Kenya has shrunk, mostly through passive disinvestment (i e , not replacing depreciated capital investment) and in some cases active disinvestment, especially by U.S. firms (Firestone, Mobil). 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

II C.1. Manufacturing

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.

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. 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.

The volume of manufactured exports has actually fallen since 1973. Outside of oil and cement, manufactured exports are largely low quality goods produced predominantly for the local market, and processed food. The GOK's goal of 6.4 percent annual growth from 1989-1993 depends on the implementation of the EPZ and other export incentives; to succeed the result must be an attraction of local private, especially Asian, investment away from real estate and capital flight.

Foreign capital and capitalists were very active in building up the industrial sector, which grew rapidly until the collapse of the EAC 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 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 had little value added. In fact, in some assembly operations (automobiles, e.g.), manufacturing produced negative value added and cost the country more foreign exchange than imports of the finished goods would have cost. The manufacturing sector as a whole is a net user of foreign exchange.

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 increased, taking the place of foreign capital, and to a lesser extent, replacing 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 were purchased 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 and has come through joint ventures with well connected individuals, who offer political protection in return for a share in the profits Although larger firms (over 50 people) provide over 80 percent of GDP, smaller firms are increasing their relative share.

II C.2 Agriculture

Despite a gradual decline in importance since the mid-1970s, agriculture is still the most important contributor to GDP, about 30% 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 far exceeds coffee or tea, it is likely that where feasible, land will converted away from these crops

Parastatal involvement in the agricultural sector is far greater than would appear by its minuscule contribution to agricultural GDP (less than one percent). 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.

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, the 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

A.C.3 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% in the 1965 - 1980 period to 5.5% in the 1980 - 1988 period, this decline 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; these 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.

III. Constraints to Private Sector Growth

Constraints to private sector growth flow primarily from three sources· adverse world-wide market conditions, GOK policy, and 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 is 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

III.A Constraints Due to 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).

Competition from a majority-ruled South Africa, if it becomes a player in regional markets, would be substantially stiffened, especially in manufactured goods.

III B Constraints Due to Government Policies

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. Their record is examined in section four.

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 and 2/ IMF-mandated credit targets that are part of on-going stabilization efforts aimed at reducing inflationary pressures In this context of scarcity, GOK mandated interest rate ceilings force 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 somehow can come up with 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 equity raised on the stock markets very high, it provides an unattractive means of raising finance, or for a successful entrepreneur to "sell out" In addition, lax accounting regulations and practices means 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, 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 generates a scarcity of inputs available to domestic businesses.

Import restrictions, including punitive import duties, while designed to protect domestic industry, force local producers to use low quality, high cost inputs. Thus, they are uncompetitive in overseas markets, and need 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 sets the stage for high cost production, inefficient provision of services, and massive embezzlement in many parastatals.

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

Grand Corruption. Successful businesses (and prospective investors) are often obliged to involuntarily give a share of the equity to prominent politicians; thus, there is a significant upside risk to doing business in Kenya

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, many 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

III C Constraints Due to the Short History of Development

Kenya's human resources 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, Lebanese and other expatriates)

Infrastructure 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; prestige construction projects are favored.

A mercantilist, rent-seeking approach to profits is only slowly giving way to a competitive, free-enterprise capitalism on the part of much of the business sector. This transition is slowed by the policy environment discussed above.

The problems of governance, 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 enterprises. Pressures from family and clan ties also divert individual's resources into redistribution rather than investment.

III.D. 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

- Fertile land
- Pleasant climate year-round
- Diverse, beautiful scenery and cultures
- Low cost, trainable labor
- Regional business and commercial center for East Africa
- Business and entrepreneurial orientation in government, the ruling party, business, and in the general citizenry
- Preferential market access to the EEC, North America, and the PTA region

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

Agribusiness: Textiles are a particularly good example of a high priority agribusiness; relatively low-tech, labor intensive, drawing on Kenya's ability to grow fiber inexpensively, and capitalizing on quota-free, preferential access to the EEC and North American markets. Fruit processing (using the surplus output of the horticultural sector) is another very promising area.

Fresh Horticulture. 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.

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

IV Government and Donor Activities in the Private Sector

The Kenya Government's formal approach to the private 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 entrepenurialism guided by government intervention Over the 1965-1980 period, this philosophy encouraged the government's increasing interventions in the economy, particularly the establishing of over 200 parastatals and marketing boards and the controls placed 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 As Kenya entered the 1980's, it's 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

IV.A. Current Government Strategy and Activities

With support from the World Bank, the Government rethought its economic growth strategy and in 1986 proposed a massive economic restructuring of the economy based on private sector-led growth. In Sessional Paper #1 of 1986 titled "Economic Management for Renewed Growth," the Government committed itself to decreasing the size and role of the public sector and to encouraging the private sector by decreasing the burdensome regulatory environment and expanding financial market opportunities.

Working with the World Bank, the International Monetary Fund and several bilateral donors, the Government has attained considerable success since 1985 in both stabilizing fiscal and monetary policy and providing incentives for private sector growth Major reforms completed that have improved the environment for private sector 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 items remaining on the control list.

* Maintaining 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.

In addition to the reforms that have been completed, there are a number of reforms that have been announced by the Government and are in various stages of implementation including

* Complete interest rate decontrol by June, 1991,

* Elimination of the anti-export bias over the 1990-92 period;

* Improving the investment climate, and

* Decreasing the role of parastatals in the economy

The Kenya Government is committed to implementing these reforms and has outlined its strategy in the recently completed 1990-92 policy framework paper.

IV.B Donor Activities in the Private Sector

The International Monetary Fund provides approximately $100 million annually 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 $220 to $240 million per year to Kenya and could increase the level to $290 to $300 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 SSEs.

For its part, USAID has provided credit to all levels of the private sector; small loans for informal and micro-enterprises, medium-term credit for rural enterprises, and loans to match equity investments. This ambitious credit program has fostered managerial and entrepreneurial development, has introduced new technology and pioneered new lending practices among financial institutions The Mission has also provided institutional support for the Investment Promotion Centre and has supported the Kenya Association of Manufacturers' undertaking a series of policy studies that directly enhanced the private sector's influence over policy Finally, the Mission has also utilized PVO/NGOs to channel technical assistance and credit to Kenya's informal sector micro-enterprises.

V Overview and Strategic Objective for USAID Program

Earlier in this document, the case is made that the most pressing development problem facing Kenya is that of improving the efficiency with which the economy utilizes its rapidly expanding labor force During its first twenty-five years of independence, the GoK relied on a capital-intensive, import-substitution strategy which provided relatively few new positions for labor force entrants. As a consequence, productive employment growth fell steadily behind the growth of the labor force. To compensate, the GoK relied increasingly on direct employment provision by the government itself This alternative resulted in extremely inefficient utilization of the labor involved and has had a steadily growing adverse impact on the fiscal account, and through the fiscal account, a negative impact on the balance of payments. Today, growing balance-of-payments difficulties themselves put at risk the ability of the economy to provide employment for Kenya's increasing population The GoK now realizes that it must change the enabling environment for private sector development so as to better use the nation's most important development resource, the Kenyan people.

The basic thrust of USAID/Kenya's private sector strategy will be to improve the efficiency of investment, and thus of labor absorption, by facilitating the two transitions discussed earlier in this paper The first is a 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 The second is a shift from an inward, import-substitution orientation on policy and incentives

to an outward-looking, export-promoting set of incentives. Only in the context of such transitions will the country be able to absorb the coming wave of labor force entrants at steady or preferably increasing wages In this task, USAID will act in a supportive role to the GoK, who have the overall responsibility for the transitions and to the lead international donors, the IMF and the World Bank, who have primary responsibility (with the GoK) for ensuring that the macro-economic environment is conducive for such transitions.

In many ways, these two transitions represent both sides of the same coin The success of private-sector employment creation will depend largely upon improving the profitability of exporting, removing regulatory and physical impediments to export production and trade, and maximizing the multiplier effects of export promotion, especially on the informal sector The success of the shift to a more outward-orientation will depend upon govenment's improving the overall investment climate and reducing parastatal control of many sectors as well as the ability and willingness of the private sector, both domestic and foreign, to expand their investments in export enterprises, especially in non-traditional products

The strategic objective which the mission has selected will focus on the efficient use of labor within the economy The measure of achievement of this objective is an <u>increase in the real wage bill</u>. While there is some expectation that the policy reforms resulting from our policy dialogue will have an impact on all sectors of the economy, the Mission's program will concentrate its efforts in two particular areas which have demonstrated particular potential for improved labor absorption -- non-traditional exports and indigenous small and medium-enterprise sector. Consequently, the program will concentrate on improvement in the labor utilization capacity in these two areas

Earlier in this document, we addressed some of the political and technical difficulties involved in these two transitions. Donor support to facilitate the transitions will be necessary for their sustainability and success The IMF, the World Bank, the EEC, the Japanese and others among the bi-lateral donors are committed to working with the GoK and with the Kenyan private sector to facilitate the process In developing its private sector strategy, the Mission has consulted with these other donor agencies to ensure complementary efforts based on comparative advantage USAID's long involvement in support of private sector development in Kenya gives the Mission a special role in these efforts, particulalry in working directly with private sector institutions and enterprises Maximizing the supply response from the private sector to the reformed policy and regulatory environment will be crucial to the viability and sustainablility of the transitions

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 improve the policy environment and to improve the capacity of firms to respond to the enhanced environment both through improved technical capability and through the removal of resource bottlenecks These efforts would 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.

4/ 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 actitivities