

An Integrated Economic Analysis for Pro-poor Growth in Kenya



Foreword

This country economic report explores the interlinkages between inequality, economic development and poverty in Kenya. Starting from the assumption that improved employment and income opportunities for the poor provide the main avenue for reducing material poverty, it applies an integrated approach to economic analysis by linking analysis of employment with analyses of the business environment and of the macro-economic situation. A main conclusion drawn in the study is that not only is there a need for more pro-poor growth in order to increase the incomes for the poor, but that several aspects of severe inequality in the Kenyan society restrict the potential rate of economic growth in general. The present study is part of an on-going methodological work within Sida (a cooperation between the Department for Infrastructure and Economic Cooperation and the Department for Policy and method) aimed at achieving sharper poverty focus in economic analysis.

The study is part of a series of country studies, undertaken by Sida itself and by various Swedish universities and academic research institutes in collaboration with Sida. The main purpose of these studies is to enhance our knowledge and understanding of current economic development processes and challenges in Sweden's main partner countries for development co-operation. It is also hoped that they will have a broader academic interest and that the collaboration will serve to strengthen the Swedish academic resource base in the field of development economics.



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1 Introduction

Kenya is a country rich in both human and natural resources. Most importantly, its population is still among the best educated in Africa. Kenya is also fairly well endowed with land although of varying quality. Yet, under utilisation and unequal and insecure access to land as well as poor quality of much of the land rather than absolute shortage of land are arguably the main reasons behind the present inability of much of the agricultural population to achieve food security and a satisfactory income. In sharp contrast to many of its neighbours Kenya has a favourable geographic location and unhindered access to the sea. It has also by and large been spared violent conflict, unlike many other countries in sub-Saharan Africa. Yet, Kenya has become one of the poorest countries in Africa, with a per capita income of about 400 USD that is little more than a dollar per day.¹ Poverty, in all its dimensions, is endemic and has worsened over time. It is exacerbated by a very high degree of inequality.

This rather dismal situation can largely be ascribed to almost two decades of economic stagnation, which combined with continued high population growth has resulted in a secular fall in per capita income and a steady increase in poverty and rising unemployment and underemployment, i.e. under utilisation of the labour force. Kenya has a history going back to the colonial days of being a highly unequal society. Independence brought little change in this regard and over the past decades inequality has become entrenched. A comparatively high level of human resources development, not least with regard to education, and a fairly well developed physical infrastructure gave Kenya an edge over its neighbours in the past. However, in particular the physical, but also the human capital has been eroded during the past long period of economic stagnation. Economic stagnation, which has implied decline in per capita terms, has gradually also taken a toll on social indicators pertaining to health and previous comparative advantages in terms of well-developed infrastructure – viz. roads, ports, electricity – have more or less been lost. This stagnation has by and large been due to poor governance and inappropriate policies.

The shift from authoritarian rule to democracy and an impressive reform agenda of the new government, backed up by popular support and demand for change, has created a window of opportunity to break the negative trends in economic and social development. There are also

¹ World Development Indicators 05 (2005: 23).

signs of an incipient turn around in economic development. Economic growth is increasing and, though still modest, is now higher than population growth implying a growth in per capita income. Economic investments are also picking up somewhat from a very low level. Introduction of free primary education has resulted in sharp increase in enrolment. Yet, the changes for the better are still modest and inevitably fragile. While economic growth is seen in several sectors of the economy (tourism, trade, construction, transport and to a certain extent in manufacturing) it still does not amount to a broad based growth and has yet to make an impact on income poverty.

The integrated economic analysis in the present study focuses on the economic dimensions of poverty, on economic growth and on the distributional aspects of growth. Starting from the assumption that improved employment and income opportunities for the poor provide the main avenue for reducing material poverty, it links analysis of employment with analyses of the climate for business (investments and entrepreneurship) and of the macro-economic situation. Hence, the study is inevitably broad in scope. However, it does not aim to be comprehensive or by any means exhaustive. It draws on the findings of other more in-depth studies, with the aim to put together bits and pieces of existing knowledge to present an overall picture rather than to repeat what others have already done. The aim of this integrated economic analysis approach is to find the underlying bottlenecks of poverty reducing economic growth.

Section 2 present the underlying methodology and motivation for an integrated economic analysis where poverty analysis, labour and employment analysis, macroeconomic analysis and business environment analysis are inter-linked. Section 3 presents the overall economic structure and the current picture of poverty in Kenya. The motivation for pro-poor growth policies in Kenya is presented in Section 4. The income and employment presentation in Section 5 includes the current structure of employment and income as well as a labour market analysis. Section 6 discusses the room for growth and employment given the macroeconomic environment. The restrictions for further business development and hence employment and income opportunities, with a special focus on the poor, are discussed in Section 7. The main conclusions and implications are summarised in Section 8.

2 Methodology

It is crucial for a pro-poor analysis to consider the poor not only as consumers who should get a piece of the country's growth, but also as workers, which makes a labour market analysis necessary, and as producers, which makes a business climate analysis necessary. It is also important to analyse the macro economic environment that to a large extent determines the parameters for economic development and policies, but also mirrors strengths and weaknesses in the economy. With this view on pro-poor growth, an integrated economic analysis becomes necessary in order to find the bottlenecks for improving incomes and reducing material poverty.

It is similarly important to have a dynamic view on employment in order to capture occupational and geographic mobility and the role of returns to labour and wages as instruments for guiding labour to where their contribution to growth will be highest. This determines the possibilities for structural changes and hence the extent to which pro-poor growth policies need to focus on specific sectors or areas, or if the most efficient link to the poor is by improving the functioning of the labour market and business environment. It is assumed that improved employment and income opportunities for the poor is the main way to reduce material poverty reduction, i.e. that poor people gets a chance to participate fully and on an equal footing in economic activities and to derive the full benefits from this participation.

Figure 1. Integrated economic analysis of pro-poor growth

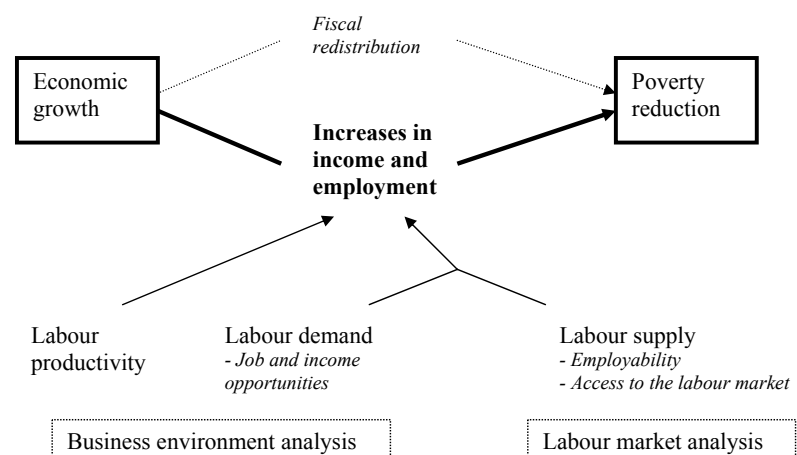


Figure 1 describes how the business environment and the labour market are affecting economic growth as well as the poverty elasticity of growth through changes in employment, productivity and incomes. Employment and the remuneration derived from employment are determined by the supply and demand for labour. A labour market analysis casts light on the supply side of labour and the functioning of the labour market, while a business environment analysis gives insights on the level of, potentials for and constraints to economic activities and the resulting demand for and, through productivity, returns to labour.

The size of the population and the age structure, which combined give the working-age population, set the outer limits for the size of the labour force. The working-age population (typically comprising the 15 – 65 age brackets, although variations exist) can be divided into the economically active – the labour force – and the economically non-active.²

The labour force is subdivided into two categories: the employed and the unemployed, the latter consist of those who are without work but available for work and seeking work. Under-employed is often added as a subcategory of the employed. Under-employed are those who lack sufficient work or, more commonly, are trapped in employment of such low productivity that it – despite long, hard hours – pays too little to enable them to escape poverty.

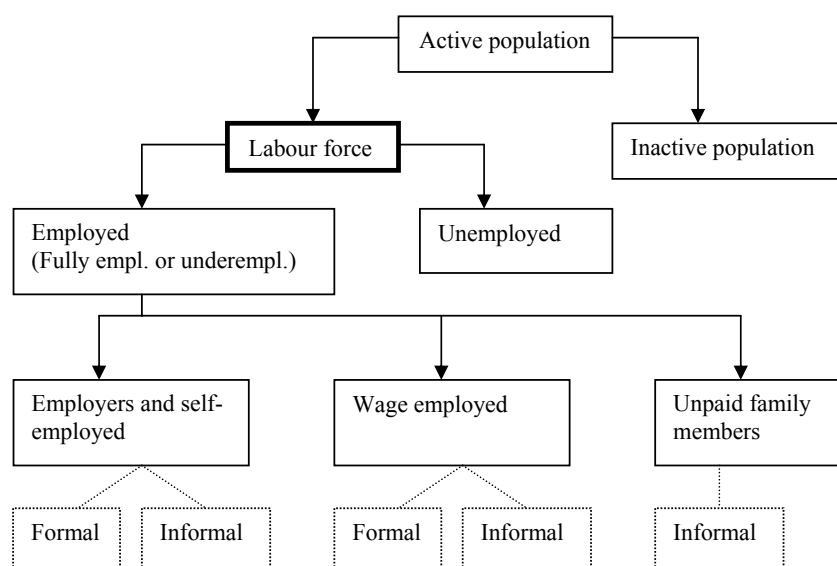
The employed can be sub-divided into three types according to their employment status: employers (self-employed and owners of firms with employees), wage employed (employees) and unpaid family helpers. It should be noted that while the income of wage employed is a result of negotiations and at times legislation, the income of employers and self-employed is essentially determined by the profitability of their own businesses. Hence, the category ‘employers and self-employed’ in Figure 2 are practically identical with the category ‘investors and entrepreneurs’ in Figure 3.³ The income of employers and self-employed is dependent not only on the quantity and quality of the supply of their labour but also, crucially, on their ability to market the goods and services they produce, that is their ability to create a demand for their own labour. Hence, a business environment analysis becomes essential for understanding the employment and income opportunities for this category of labour, as well as indirectly and more generally for all types of labour.

The employed can also be sub-divided into a formal and an informal labour force. The former consist of wage-workers in regular, contract-based employment and employers and self-employed in registered, formal sector enterprises. The latter consists of the rest of the labour force, who are not at all or only poorly covered by any legislative or regulative framework. The division of the labour force into with formal/informal employment is a direct reflection of the division of the economy into formal and non-formal parts, which in its turn is very much in the focus of a business environment analysis. Hence, a business environment analysis is indirectly an analysis of how to formalise the the informal economy and hence an analysis of the possibilities for the poor to gain, usually qualitatively superior, employment in the formal economy.

² Among the many reasons for not participating in the labour force can be mentioned school attendance, disabilities or illness and household duties. The participation rate in the labour force tends to be lower for women than for men as a result of a situation where women have to bear the brunt of the burden of child-rearing and household work and thus have little time left for economic activities. Outright gender discrimination – women's lives should focus on ‘kinder, kirche und küche’ – can also reduce the scope for women to participate in the labour force. Another important reason for not being part of the labour force is often also sheer resignation; a perception that there simply is no work available.

³ The only difference between the two categories is that foreign investors and domestic investors / entrepreneurs who do not derive any income from own labour is included in the latter, but not the former.

Figure 2. “Employment tree”

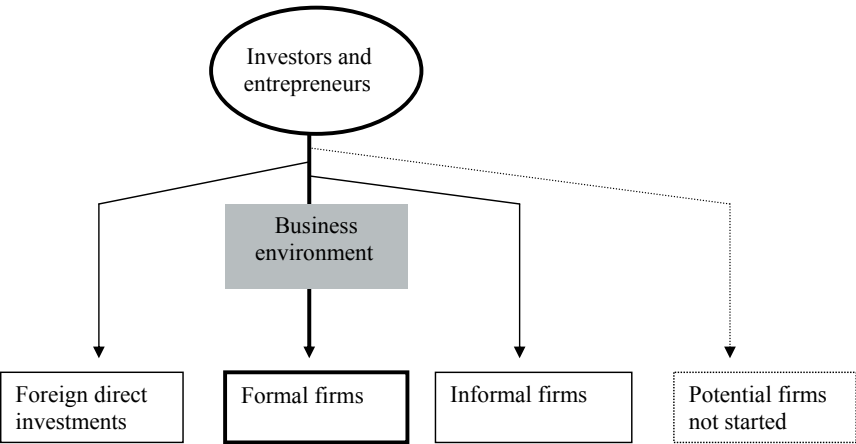


The business environment in a country and the level and type of employment is closely linked (see Figure 3). An investor that wants to start a business may soon find out that the investment environment is quite hostile – it costs a lot just to start a business as well as running a business. For a large foreign investor it may be possible to negotiate a special deal offering privileges and a better investment climate and hence a possibility to escape some of the distortions in the regular formal sector. An investment following from such a deal will create some employment opportunities, but also distort domestic competition. A potential domestic investor has three options; (1) To refrain from starting any business and hence create no employment opportunities. (2) To start a business without informing the authorities in order to escape some parts of the bad investment climate, but at the expense of losing the benefits of being formal. This will create some informal employment opportunities but those employed will not be protected by formal labour or wage regulations. Or (3) you start a formal business, but are forced to operate below its potential due to the inimical business environment and at a disadvantage vis-à-vis other competing firms (firms abroad or FDIs). This will generate some employment opportunities, but less than there could have been. Hence, a bad business environment does not only lower the level of employment, the type of employment created will also be of lower equality – both this mechanisms mainly affect the poor.

The sustainability and the vulnerability of the economic system should also be addressed throughout the analyses. Issues such as the extent of domestic demand, investment in human resources, the breadth and depth of the economy, debt sustainability, international dependence, effects on the environment and natural resources, etc, are crucial to look at in the analysis of long term pro-poor economic growth⁴.

⁴ A limitation of this study is the lack of analysis when it comes to environmental effects and the sustainability of Kenya's natural resources.

Figure 3. Effects of the business environment



3 Economic Structure and Poverty

3.1 Economic Structure

Agriculture remains the dominant activity in the economy, particularly in terms of employment and incomes and export earnings and to a lesser degree in terms of contribution to GDP. About a quarter of Kenya's GDP originates from agriculture and forestry (Table 2). Agricultural production has displayed large fluctuations around a largely stagnating trend, reflecting a lack of irrigation and dependence on unpredictable rainfall and climatic conditions (Table 1). Despite a reputation of having a stronger industrial base than neighbouring countries, manufacturing remains poorly developed and account for little more than 10 per cent of GDP. The past two years have seen a modest growth in manufacturing, implying a welcome break from a more than decade long trend of stagnation. However, this growth is still too fragile and too low to form the basis of optimistic forecasts. Trade, hotels and restaurants and transport and communication combined account for about a quarter of GDP.

Table 1. Growth of selected activities and sectors. Value added. Percentages.

	2000	2001	2002	2003	2004
Agriculture & forestry	-1.2	10.6	-3.1	2.6	1.4
Manufacturing	0.7	0.3	0.6	4.9	4.1
– agro processing	-5.0	-1.0	1.2	2.9	7.2
Construction	-5.4	3.8	-2.6	1.7	3.5
Trade	-0.5	4.6	-2.3	1.2	9.5
Hotel & restaurants	10.0	-3.4	4.7	-20.3	15.1
Transport & communications	7.5	12.5	6.8	4.9	9.7
Financial services	-3.8	-9.6	-1.8	1.7	1.5
Public administration	-0.4	-3.1	-0.1	0.6	0.1
Education	0.5	3.2	2.0	6.5	1.4
Health and social work	4.4	1.8	3.4	2.8	3.8
All activities	0.6	4.4	0.4	2.8	4.3
Non-government	0.3	6.0	0.6	3.0	4.2
Government	0.5	-0.7	0.0	2.6	1.8

Source: Economic Survey 2005 (2005: 28).

Through tourism these sectors are also major foreign exchange earners. However, tourism is a fragile “sector” and is highly vulnerable to chang-

es in the security situation. Only during the past few years, the growth rate of trade, hotels and restaurants has ranged from -20 to +15 per cent (Table 1). The public sector accounts for approximately a quarter of GDP. This share has remained more or less constant over the past five years.

Table 2. Contribution to GDP by selected activities and sectors. Percentages.

	2000	2001	2002	2003	2004
Agriculture and forestry	28.4	27.0	24.9	24.6	23.7
Manufacturing	11.4	10.9	10.9	11.1	11.2
– agro-processing	3.3	3.1	3.1	3.1	3.3
Construction	3.5	3.5	3.4	3.3	3.3
Trade, hotel & restaurants	11.7	11.5	11.3	10.8	11.5
Transport & communication	10.1	10.8	11.5	12.0	12.4
Financial services	5.4	4.6	4.5	4.5	4.4
Public administration	5.6	5.1	5.1	5.0	4.8
Education	7.0	6.9	7.0	7.2	7.1
Health and social work	2.7	2.6	2.7	2.7	2.7
All activities	100.0	100.0	100.0	100.0	100.0
Non-government	74.4	75.6	75.7	75.9	75.8
General government	25.6	24.4	24.3	24.1	24.2

Source: Economic Survey 2005 (2005: 27).

3.2 Poverty

More than half of Kenya's population live in poverty.⁵ Poverty increased sharply in the early 1990s and following a few years of decline in the mid-90s has risen steadily since 1997. By 2003 it is estimated that some 56 per cent of the population lived in poverty,⁶ as against 45 per cent in 1990 (Table 3). As population growth has been high throughout this period, the number of people living in poverty has increased dramatically.⁷ The very high rates of poverty are the combined effect of a low level of economic development and a very high rate of inequality. Not only is the cake small, it is also very unequally divided. The share of the population living in poverty has increased faster in urban areas than in rural areas and poverty is today almost as much an urban as a rural phenomenon. At present it is estimated that half of the population in Nairobi is living in poverty, putting it close to the national average.⁸ However, some of the fundamental causes of poverty, not only in rural but also in urban areas, are rural in origin as a major reason behind the sharp increase in urban poverty has been the steady inflow of poor people from rural areas in search of better prospects to escape poverty. The failure of the urban economy to provide the poor, whether migrants or not, with prospects of material improvement is another obvious cause of the increase in urban poverty. The Government is undoubtedly right when it identifies low agricultural productivity, poor access to markets, unemployment and under-employment as some of the key causes of poverty.⁹

⁵ The purpose of this section is only to provide a brief overview of the characteristics and determinants of income poverty in Kenya. For a more in depth analysis of poverty and, in particular, inequality in Kenya, the reader is referred to Pulling Apart (2004).

⁶ PRSP (2004: 9).

⁷ PRSP (2004: 9).

⁸ PRSP (2004: 9).

⁹ PRSP (2004: 10).

There are also large regional differences in poverty. Poverty is most widespread in the Nyanza and North Western provinces, while the Central Province has the lowest incidence of poverty. Poverty is particularly severe in the arid and semi-arid areas, where over two thirds of the population live in poverty. Intra-regional variations in poverty are at least as large as the cross regional. For instance, rural poverty rates within the Central Province range from 10 to 56 per cent across 171 locations. In the Coastal Province, with an average rate of 61 per cent, poverty ranged from 13 to 90 per cent across 140 rural locations.¹⁰

Hard core poverty, defined as being unable to meet basic food requirements even if all the income is used on food, was in 1997 still much more widespread in rural than in urban areas; at 35 versus 8 per cent. However, the high general level of hard core poverty (34 per cent in 1997) and the fact that it increased at a faster rate than overall poverty is an issue of greater concern.¹¹

Income poverty is greatly exacerbated by a highly unequal distribution of incomes. Thus, the 1999 Labour Force Survey revealed that only 2.5 per cent of the total disposable personal income (household income) was accrued by the 20 per cent poorest households, while a staggering 57 per cent went to the richest 20 per cent of the households. The poorest 60 per cent of the households combined accounted for only a fifth of all household income.¹²

Table 3. Percentage of people living in poverty.

	1992	1994	1997
Rural areas	48.9	46.8	52.9
Urban areas	29.3	29.0	49.2
All areas	44.8	20.3	52.3

Source: Poverty in Kenya (2000a: 40).

Along with increased income poverty, many social indicators have also worsened. Life expectancy has fallen from 58 years in 1986 to 44 years in 2003, partly due to an increasingly heavy toll of HIV/AIDS on in particular the 20 – 35 age groups, but also as a consequence of generally worsening health standards and an increase in infant and child mortality to 79 and 123 per mille, respectively in 2003.¹³

Poverty is particularly widespread within certain socio-economic groups, such as small-scale farmers, pastoralists, agricultural and casual wagedworkers, physically handicapped, AIDS orphans and street children. Household size, educational status, occupational status and the sex of the head of household are factors having a major influence on the propensity to be poor. In 1997, the average size of a poor household was 5.3, against 4.0 for non-poor households and a country average of 4.6. The size of household was typically higher in rural than in urban areas, but the difference in size between poor and non-poor households applied equally to both areas.¹⁴ The close relationship between household size and poverty is a near-universal phenomenon and reflects the importance of the dependency ratio, that is the relationship between the number of income earners in a household and the total number of people in a

¹⁰ PRSP (2004: 9).

¹¹ Poverty in Kenya (2000c: 5-7). Unfortunately, it would seem that no comparable later data exist.

¹² Pulling Apart (2004: 6).

¹³ African Development Bank (2005: 11-12), World Bank (2005).

¹⁴ Poverty in Kenya (2000a: 8).

household that live from the income derived by the income earners. In urban areas female-headed households have been found to be considerably more prone to be poor than male headed households, while in rural areas this difference would seem much smaller.¹⁵ Both the educational and occupational status has a strong bearing on poverty. Generally speaking, the higher the education the less the risk of being poor. Households depending on agriculture as their main source of income are particularly exposed to poverty. Among the non-farm households, the risk of poverty varies greatly not least by employment status and sector of employment. These aspects are explored at greater length below.

¹⁵ Poverty in Kenya (2000a: 8).

4 Employment and Income Generation

The economically active population increased from 7.8 million in 1989 to 12.4 million in 1999, i.e. by 59 per cent. Total population increased from 21.4 to 28.7 million the same period implying an improvement in the dependency ratio (measured as economically active population as a share of the total population) from 0.37 to 0.43 (Table 4). Under more favourable economic conditions this demographic change would in itself have implied a considerable reduction in poverty even at constant levels of labour productivity and incomes, as the number of mouths to feed per breadwinner was reduced. However, very sluggish economic growth implied that the increase in the labour force took place at the expense of labour productivity. Over the same period GDP grew by a mere 23 per cent suggesting an overall fall in labour productivity and incomes of about 22 per cent over the period (Table 4). This fall took two forms: (i) an increase in open unemployment and (ii) increased underemployment, that is an increase in the number of economically active people who could and would have worked more and, more probably more importantly, an increase in the number of people who got trapped in employment of such low productivity that – despite long, hard hours of daily work, paid too little to enable them to escape poverty.

Table 4. Population, employment and growth 1989–1999.

	Change	% change
Population (1,000)	7,286	34.0
Labour force (15–64), 1,000)	4,561	58.2
GDP		22.8
Dependency ratio	0.07	+18
GDP/capita		
Labour productivity, GDP/worker		-22.4
Agriculture		
– Labour force (1,000)	1,625	36.6
– GDP		6.6
– Labour productivity		-22

Sources: Oxford Policy Management (2001: tab 3.3); Census 1999 (2002b: Tab 2.3); Census 1989 (1996: pp 5 & 32).

Remark: Non-wage rural labour force used as estimate for agricultural labour force in 1989. For 1999 self-employed in family farm used as proxy.

The twin problem of a stagnation of agricultural production at a generally low level of production, made worse by unequal access to productive land, and a much too slow growth of employment opportunities in the modern non-farm sectors squeezed labour out of agriculture into the informal economy in both rural and urban areas and created a strong push factor for rural – urban migration.

Agricultural production remained virtually constant throughout the 1990s at the same time as an estimate suggests that the labour force, overall increased by close to 60 per cent per cent (Table 4).¹⁶ A large part of the agricultural labour force left agriculture for work in the informal non-farm sector. For many, but far from all, this occupational shift was combined with migration to urban areas. Still, a rough estimate suggests that the agricultural labour force increased by approximately 37 per cent over the decade (Table 4).¹⁷ At the same time, the returns to labour in agriculture fell by a staggering 22 per cent from an already low level (Table 4). The stagnation in agricultural production also reduced food security and the ability of the rural population to rely on own production for the food consumption needs. Assuming that the growth of the potential labour in the rural areas is the same as in the overall economy, i.e. 58 per cent, there seems as if 21 per cent of the rural labour force has migrated to the urban area. If this migration had not occurred, the agricultural labour productivity would have decreased by as much as a third. Over the same period, i.e. the 1990s, it would appear that public and private sector wage employment increased by a mere 300,000.¹⁸ The insignificance of this increase in wage employment is perhaps best seen when cast against the total increase of the labour force by some 7.3 million.

4.1 The Role of Agriculture

By 1997 a mere 32 per cent of the food consumed by the rural poor and non-poor alike derived from own production. The share of own production in the food consumption varied regionally, but did not exceed 40 per cent in any province.¹⁹ The very heavy dependence on purchased food reflects both a highly unequal distribution of land and the generally depressed state of agriculture. Some 3,600 large landowners control 39 per cent of all arable land in the country, while some 3.5 million smallholders share less than half of the arable land, giving them an average of 1.2 ha (slightly less than three acres) per household.²⁰ As a consequence of this skewed land-holding structure, working as agricultural labourers on large farms and plantations provides the main source of income and employment for many of the rural poor. In 1997 some 11 per cent of the rural poor and 17 per cent of the rural non-poor had no land. This suggests that the rural landless were highly heterogeneous. It will have included public sector wagedworkers and successful entrepreneurs as well as a genuine landless proletariat. A further 33 of the poor and 31 per cent of the non-poor households had less than two acres of land (i.e. about 1 hectare), which by any standard was too little to provide an income above the poverty line or even food security. With an average yield of no more than two thousand kilos per hectare of maize (the main crop) and a

¹⁶ Assuming equal growth and propensity to join the labour force in rural and urban areas.

¹⁷ Differences in the methodologies used in the 1989 and 1999 population censuses unfortunately preclude exact comparisons.

¹⁸ Opportunities for fostering pro-poor growth (2001: Table 3.5)

¹⁹ Poverty in Kenya (2000a: 57).

²⁰ Kenya Rural Development Strategy (2002: 11.).

farm gate price for maize of little more than 15 shillings per kilo (in 2004), two acres of land, cultivated with maize, would yield a gross income of less than 15,000 shillings or about 200 USD.²¹ In view of the very low average yields, the potential for increasing production and incomes through more intensive cultivation is clearly large. The Kenya Rural Development Strategy of 2002 suggests that the yield of maize might be trebled, from two to six tonnes per hectare. Even a doubling of the present yields would clearly have a very large impact indeed on both poverty and rural economic growth. This should be technically possible without irrigation and with relatively modest increases in cash inputs in agriculture. Intensification of agriculture stands out as a primary avenue for reducing poverty and inequality and fostering sustainable economic growth. The obstacles standing in the way of such a development are explored in Section 7 on the business environment below.

As can be seen from Table 5 the size of land holding is not a main determinant of poverty in rural areas. Poor and non-poor alike hold on average slightly more than four acres, or approximately two hectares, of land. However, these figures are likely to conceal more than they reveal. First, the quality of land varies greatly between different regions and areas. While four hectares may suffice to feed a family in some areas, it is totally inadequate in other areas. Second, it seems reasonable to believe that non-farm income may be an important determinant of the overall level of household income in rural areas.²² An indication that both of the above factors are at work is the fact that non-poor rural households spent almost three times as much as poor rural households on farm cash inputs. This suggests on the one hand that the non-poor have more access to non-farm cash incomes that can be invested in agricultural production and on the other hand that non-poor households obtain a considerably higher production and return per unit of land as a consequence of using more cash inputs in agriculture, such as fertilisers and improved seeds. Put differently, the non-poor are likely to have the means to cultivate their land more intensively and, conversely, poverty is in itself an obstacle to intensification of agriculture. This also would be consistent with the findings of a study by Collier and Lal more than thirty years ago.²³ Third, the extremely skewed distribution of land implies that not only the poor, but also the vast majority of the non-poor in rural areas belong to the category of smallholders who jointly hold less than half of the arable land.

Table 5. Access to land and farm and non-farm enterprise expenditures.

	Avg. land holding (acres)		Farm expenditures (Ksh)		Non farm enterprise expenditures (Ksh)	
	Poor	Non-poor	Poor	Non-poor	Poor	Non-poor
Rural areas	4.3	4.2	1,748	4,718	65	284
Urban areas	1.5	3.9	1,039	5,080	487	846
All areas	3.8	4.1	1,611	4,795	146	403

Source: Poverty in Kenya (2000a: 39–42).

²¹ Economic Survey 2005 (2005: 145). The average farm gate price of maize was 15 shillings in 2004, up from 12 shillings in 2003.

²² Unfortunately, the 1997 poverty survey did not yield any information on this.

²³ Collier and Lal (1980)

4.2 Types of Employment

Rural to urban migration added considerably to an already rapidly growing urban population and labour force. Between 1989 and 1999 the urban labour force increased from 1.6 to 2.8 million, that is by a staggering 75 per cent (Table 6). Slums developed at a rapid pace to accommodate the increasing population, while the informal urban economy assumed the role of an employment buffer. A rapid inflow of people in desperate search for a livelihood, rather than economic growth opportunities, was, and remains, clearly a main factor behind the ‘dynamism’ of the urban informal economy. In rural areas, the push of labour out of agriculture resulted in a proliferation of non-farm distress activities rather than a sound and dynamic diversification of the rural economy.

Table 6. Rural-urban distribution of the labour force.

	1989	1999	Change	% change
Labour force (1,000)				
– total	7,834	12,396	4,561	57.2
– rural	6,224	9,578	3,354	53.9
– urban	1,610	2,818	1,207	75.0

Source: Census 1999 (2002b: Table 2.4).

By 1999 open unemployment stood at 10 per cent (Table 7). Women were consistently more affected by unemployment than men. In urban areas 24 per cent of the female labour force, as against 14 per cent of the male labour force were unemployed.

Table 7. Labour force by employment status, area and sex 1999 (15–64).

	Labour force (1,000)	Employed (1,000)	Unemployed (1,000)	% employed	% unem- ployed
Kenya					
– total	12,396	11,145	1,251	89.9	10.1
– male	6,376	5,838	537	91.6	8.4
– female	6,020	5,306	714	88.1	11.9
Rural					
– total	9,578	8,825	753	92.1	7.9
– male	4,699	4,391	309	94.4	5.6
– female	4,879	4,434	444	90.9	9.1
Urban					
– total	2,818	2,320	498	82.3	17.7
– male	1,676	1,448	229	86.4	13.6
– female	1,142	872	269	76.4	23.6

Source: Census 1999 (2002b: Tables 2.7, 3.8 and 4.2).

Table 8. Employment by area and sex. 15–64 age group. Percentages.

	Employment (1,000)	Wage employ- ment	Farm	Self-employed non-farm
Kenya				
– total	11,145	31.0	54.4	14.6
– male	5,838	42.3	43.7	13.9
– female	5,306	18.6	66.2	15.3
Rural				
– total	8,825	22.0	66.4	11.6
– male	4,391	32.3	56.2	11.5
– female	4,434	11.8	76.5	11.7
Urban				
– total	2,320	65.3	8.8	25.9
– male	1,448	72.8	5.9	21.3
– female	872	52.9	13.5	33.5

Source: Census 1999 (2002b: Table 3.8.).

By 1999 some 31 per cent of Kenya's labour force was employed, on a regular or casual basis, for wages. However, wage employment was largely a realm for men. Some 42 per cent of the men but only 19 per cent of the women derived their main income from wage labour (Table 8). However, wage employment should not be equated with formal sector employment or even a regular source of income, as it was also found in agriculture and in the informal economy and as casual wage employment existed along with regular employment. As might be expected, wage employment was less important in rural than in urban areas. Still, some 22 per cent of the rural labour force, mostly men, worked for wages (Table 8). This surprisingly high figure reflects not least the importance of large farms and plantations in the economy. In urban areas, working for wages was the main form of employment (Table 8). Wage employment by itself was no guarantee for protection against poverty. Casual waged workers were more exposed to poverty than the labour force at large. Only within the ranks of skilled regular waged workers was the exposure to poverty substantially reduced (Table 9).

Non-farm self-employment accounted for about 15 per cent of the country's labour force in 1999. This share was higher in urban areas (26 per cent) than in rural areas (12 per cent) (Table 8). In rural areas non-farm employment was equally common among men and women, while in urban areas a third of the female labour force, as against 21 per cent of the male labour force were self employed.

Work on the family farm provided the main source of living for little more than half the labour of the country's labour force. The flight from agriculture was primarily a male phenomenon. It dates back to colonial times and the introduction of identity cards and taxation of men. By 1999 more than three quarters of the rural female labour force, as against 56 per cent of the male labour force worked primarily on their own farm (Table 8).

4.3 Employment and Poverty

Self-employed were more exposed to poverty than other categories of the labour force (Table 9). Unpaid family workers were particularly exposed to poverty. As more than 70 per cent of the rural and 90 per cent of the urban unpaid family workers were female, it follows that female-headed households were particularly afflicted by poverty.

Table 9. Employment status of household heads among poor and non-poor.
Percentages.

Employment status	Rural areas		Urban areas		All areas	
	Poor	Non-poor	Poor	Non-poor	Poor	Non-poor
Unemployed	6.2	4.2	3.6	1.9	5.8	3.7
Employer	0.3	0.5	1.1	2.7	0.4	1.0
Regular employee, skilled	4.0	16.5	31.1	46.6	8.7	22.6
Regular employee, unskilled	0.3	0.5	1.1	2.7	0.4	1.0
Casual employee, skilled	2.3	2.9	9.7	4.8	3.6	3.3
Casual employee, unskilled	9.1	8.2	11.9	9.3	9.6	8.4
Own account worker	43.2	41.3	26.3	27.1	40.3	38.4
Unpaid family worker	32.3	23.3	13.8	2.9	29.1	19.2
Not in labour force	2.3	2.6	0.9	2.0	1.8	2.5
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Poverty in Kenya (2000b: Table 6.7).

Remark: The figures in this table should not be compared with those in earlier tables as they refer to heads of households only.

Poverty and under-employment, in the form of hard work at very low levels of productivity and incomes, is clearly a main reason behind the widespread existence of child labour. The 1999 population census recorded a total of almost 2.7 million economically active children aged 5–14, of whom more than 1.1 million were less than ten years old.²⁴ In percentage terms, some 7.3 of the 5–9 year old and 9.7 per cent of the 10–14 year old were classified as economically active. Child labour was slightly more common among boys than girls and to a very large extent a rural phenomenon. Approximately 38 per cent of all rural children aged 5–14 were found to be economically active, as against 9 per cent of those in urban areas.²⁵ Work on family farm was by far the common form of child labour, although there were also instances of child wage labour. One of several harmful effects of child labour is school absenteeism. The same census found that only 18 per cent of all children aged 5–17 were attending school. The propensity to attend school was much higher in urban areas (46 per cent) than in rural areas (17 per cent) and somewhat higher among girls than boys.²⁶

Table 10. The share of poor and non-poor by sector of employment.
Percentages.

	Public sector		Semi-public		Private formal		Private informal	
	Poor	Non-poor	Poor	Non-poor	Poor	Non-poor	Poor	Non-poor
Rural areas	4.2	12.8	1.5	1.9	13.1	19.6	81.1	65.7
Urban areas	9.5	15.8	2.9	6.2	21.7	30.9	65.9	47.1
All areas	5.6	13.6	1.9	3.0	15.2	22.5	77.3	60.9

Source: Poverty in Kenya (2000b: Table 6.5)

Remark: Private informal include own farm.

²⁴ Census 1999 (2002: 8). Economically active (children) were defined as those who had worked, irrespective of how much, during the week preceding the census.

²⁵ Census 1999 (2002: 33).

²⁶ Census 1999 (2002: 36).

The sector of employment rather than employment status or industry would seem to be the main determinant of whether the employment provided sufficient income to escape poverty (Table 10). More than three quarters of the working poor, as against 61 per cent of the non-poor, worked in the private informal sector (including work on own farm). The discrepancy was particularly large in urban areas; 66 versus 47 per cent. In rural areas the discrepancy was somewhat smaller, suggesting that employment at such low levels of productivity that it did not permit escape from poverty was more common in the non-farm informal sector than in agriculture. This is consistent with the conclusion that the informal sector, in both rural and urban areas, was forced to assume the role of an employment buffer and that labour was pushed rather than pulled into this sector. However, as can be seen from Table 10, formal sector employment, whether private or public, provided no guarantee for escape from poverty.²⁷

4.4 Recent Trends

The dismal trends of the 1990s have continued and may even have been exacerbated in the subsequent years, although lack of comparable statistics precludes a detailed and exact analysis. The total non-farm labour force is estimated to have increased by some 1.8 million, or 450,000 per year, between 2000 and 2004, corresponding to an increase of over 30 per cent (or close to 8 per cent a year).²⁸ Meanwhile employment in modern (formal) establishments increased by a mere 68 thousand, thus absorbing less than 4 per cent of the increase in the labour force. The remaining 96 per cent of the increase in the labour force were primarily absorbed in the informal economy. The dismal employment growth in the modern sector was the combined result of a five per cent fall in public sector employment and a 10 per cent increase (approximately 100,000 people) in modern private sector employment over the period.

As the non-agricultural GDP increased by a mere 10 per cent over the same period and the non-farm labour force by over 30 per cent,²⁹ it can easily be seen that the long-standing trend of falling labour productivity has continued up to the present. Indeed, if the labour force estimates given in Economic Survey 2005 are correct, this would imply that labour productivity fell by as much as a quarter between 2000 and 2004.

The fortunate few employed in the modern (formal) private sector and in the public sector have registered considerable real wage increases since 2000. Average real wages in these two sectors increased by 32 per cent between 2000 and 2004; somewhat higher in the private sector (36 per cent) than in the public sector (25 per cent).³⁰ Wage gaps increased over the period as wage increases in high wage industries such as electricity and water, business services or transport and communication increased at a much faster rate than in low wage sectors, such as agriculture and forestry. By 2004 the average wage in private sector agriculture was little more than a third (8,865 Ksh/month) of the average private sector wage (24,280 Ksh/month).³¹ However, the real losers were clearly the vast majority of economically active people who could not access public or

²⁷ It should be remembered that other factors than employment, such as size of household, also have a bearing on poverty status.

²⁸ Economic Survey 2005 (2005: 69). These figures seem to be based on a much more narrow definition of the labour force than that used in the population censuses. It excludes own-account farmers and pastoralists. In the absence of any full-coverage census they are clearly also based on estimates.

²⁹ Economic Survey 2005 (2005: 9)

³⁰ Economic Survey 2005 (2005: 77).

³¹ Economic Survey 2005 (2005: 75 and 77).

modern private sector employment. It is reasonable to assume that the vast majority of them suffered a further, and more often than not substantial, fall in real incomes over the period. The fact that this fall may not have been fully translated into falling overall per capita incomes and increases in material poverty can only be ascribed to further improvements in the dependency ratio, which, as in the 1990s, continued to cushion the impact of falling returns to labour.

In the absence of comprehensive surveys, statistics on employment in the informal non-farm economy – *jua kali* – are inevitably approximate. Still, official information suggests that employment in this sector increased by 42 per cent – from 4.2 million to 6.0 million – between 2000 and 2004 (Table 11). It would also seem that the increase was approximately equally fast in rural and urban areas. Trade, hotels and restaurants were the most common industry of informal sector employment (59 per cent), followed by manufacturing (21 per cent).³²

Table 11. Informal non-farm sector employment 2000–2004 by area.

Area	2000	2004	Change	% change
Urban	1,433	2,036	603	42
– Nairobi	1,009	1,440	431	43
Rural	2,758	3,934	1,176	43
All areas	4,191	5,971	1,780	42

Source: Economic Survey 2005 (2005: 78).

The very broad based population pyramid with a large share of children and youth in the population and still high rates of natural increase imply that the Kenyan labour force will continue to increase at very rapid pace for the foreseeable future. A rough calculation based on these demographic realities suggests that over 800,000 young people will enter the active age groups each year in the coming decade. Meanwhile, attrition through retirement will probably not exceed 100,000 per year. With a labour force participation rate of 83 per cent in the 15–65 age groups, between 650,000 and 700,000 new employment opportunities will need to be created per year addition to accommodate the increase in the labour force. To this must be added a need to reduce the already large open, primarily urban, unemployment and massive underemployment in both rural and urban areas. Against this backdrop even the ambitious government target of creating 500,000 new jobs per year would seem to be inadequate.

4.5 Policy Implications

Apart from increasing the employment and income generating capacity of the economy (see section on business environment, below), enhancing employability and facilitating access of the poor to these opportunities stand out as the single most important road to reduce both income poverty and inequality. This will require efforts on two fronts simultaneously:

- Enhancing the employability and attractiveness of the poor on the labour market through investment in their human resources.
- Fostering labour mobility from occupations, areas and economic sectors that are plagued by un- and underemployment and low returns to labour to other sectors of the economy with higher returns to labour and better prospects for employment generation.

³² Economic Survey 2005 (2005: 79).

4.5.1 Increasing employability: The importance of human resources development

Education deserves to be singled out as the most important determinant of employability. People who are illiterate or have little or no formal education are inevitably confined to the low productivity/low income segments of the labour markets, while education beyond the primary level should open up the doors to formal sector employment once the economy picks up.³³

It is therefore encouraging to note that the educational status of the labour force improved substantially in the 1990s (Table 12). The share of the labour force with less than one year of formal education, which may be seen as a proxy for the functionally illiterate, fell sharply in both absolute and relative terms over the period. Still, by 1999 some 18 per cent of the labour force still fell into this category. The laudable initiative by the new government to introduce free primary education will no doubt further reduce this category. As encouraging is the fact that the share of the labour force with more than five years of formal education increased from 50 per cent in 1989 to 68 per cent in 1999. A high and increasing educational status of the labour force is essential not only to equip poor people with the resources necessary to escape poverty, but also to pave the way for sustained high economic growth in an increasingly competitive international environment.

Table 12. Labour force by educational level.

	1989 (1,000)	% 1989	1999 (1,000)	1999 %
Less than 1 year	3,122	33.6	2,169	17.5
1–4 years	1,431	15.4	1,771	14.3
5–8	2,945	31.7	5,044	40.7
9–12	1,561	16.8	3,097	25.0
13–	186	2.0	315	2.5
Total	9,291	100.0	12,396	100.0

Source: Census 1999 (2002b: Tab 2.5).

By opening up access to the higher income segments of the labour market and serving to increase labour productivity generally, education provides an important vehicle for escaping income poverty. The relationship between education and income poverty is clearly demonstrated in Kenya. The 1997 poverty survey revealed that 25 per cent of the non-poor had secondary education or higher, as against only 11 per cent of the poor.³⁴ Against this backdrop, it is a cause of serious concern to note that access to education is closely related to poverty, i.e. that poor households have much less access to education, due to high costs as well as they tend to live in areas where access to formal education is more difficult. Education related costs were found to be the single most important non-food expenditure item for poor households and weighted heavier in the household budget of poor households than of the non-poor, despite the fact that children from poor households are underrepresented at all levels of education, and severely so at the secondary level and above.³⁵ Inability to afford the cost was found to be by far the most important reason for

³³ The 1999 population census showed that the share of the labour force with wage employment was about 50 per cent for those with at least some secondary education, against about 25 per cent for those with one to eight years of education (Census 1999 [2002b: 31]).

³⁴ Poverty in Kenya (2000b: Table 3.2).

³⁵ Poverty in Kenya (2000b: Tables 7.4a, 7.4b).

children of poor households not to attend school.³⁶ Thus, inability to afford education, both due to direct costs and due to high alternative costs (see the discussion on child labour in Section 4.4), becomes a vehicle for perpetuating poverty from one generation to the next. Indeed, equal access for all to free education at increasingly high levels is an equity issue of the highest order.

4.5.2 Access to employment: Improving the functioning of the labour market

However, increased levels of education and employability alone will not suffice to provide poor people equal access to and opportunities on the labour market. There exist labour market distortions that can only be characterised as discrimination, in particular against women. Women are clear losers on the Kenyan labour market, for reasons that have nothing to do with employability, productivity or economic efficiency. They are much more exposed to unemployment than men and those employed are often confined to a low employment status (viz. unpaid family workers) and to the low-income segments of the labour market. Women are also discriminated against as self-employed or entrepreneurs. In rural areas, lack of right of inheritance to land and weak property rights generally present a particularly obnoxious problem. From a rights perspective, as well as from a more general development perspective, the various forms of discrimination against women in their pursuit of economic activities require serious attention.

It would also appear that the labour market functions rather poorly in other more general respects. The poor mobility of labour from the informal to the formal (modern) economy is a particular cause of concern. The quite large increases in real wages in the modern private sector and in the public sector in the past few years discussed above, at a time when there is a large pool of grossly under-utilised labour in the urban informal economy, many of whom would meet least the educational requirements for employment in the formal economy, clearly point to severe imperfections in the urban labour market. These are imperfections that can only serve to worsen the already precarious employment situation and increase income inequality as well as reduce economic efficiency and competitiveness, and thus by implication economic growth.

Kenya has a rather detailed system of minimum wage regulations, on top of which there are also collective bargaining agreements for some categories of waged workers.³⁷ Minimum wages are set by government for different types of occupation and skills, separately for agriculture and non-farm occupations in urban areas. In agriculture the minimum wage regulations distinguish between ten categories of workers, with minimum wages ranging from 2,096 shilling per month for unskilled workers to 3,780 shillings per month for farm foremen and farm clerks to 3,789 shillings.³⁸ In urban areas a distinction is made between no less than 25 occupations as well as between three categories of urban areas. In 2004 the minimum wage spanned from 2,312 shillings per month for general labourers to 8,631 shillings per month for cashiers, drivers of heavy vehicles and highly skilled artisans. The minimum wage also varied considerably between different types of urban areas. For instance, for general labourers it ranged from 4,335 shillings per month in Nairobi,

³⁶ Poverty in Kenya (2000b: Table 3.a).

³⁷ Economic Survey 2005 (2005: 79-81).

³⁸ The figures refer to 2004.

Mombasa and Kisumu to 1,877 shillings per month in non-municipality towns. On top of the urban minimum wages was added a compulsory housing allowance and various insurances. An argument can be made from a rights perspective for a legislated minimum wage that provides a safeguard against abject exploitation and as part of a labour legislation promoting decent working conditions. Minimum wage legislation can also be used as an economic policy tool. In a situation of imperfectly functioning domestic and international capital and labour markets, minimum wage legislation can arguably also be defended on grounds of economic theory. However, for a minimum wage policy to be defended on these grounds it should be:

- As uniform as possible. There might be justification for some geographic or rural – urban differentiation on grounds of large differences in costs of living. However, differentiation across occupations distorts the functioning of the labour market to the detriment of employment creation and growth, while serving no legitimate purpose from a rights perspective.
- The level of the minimum wage needs careful consideration in order to judiciously balance the legitimate aim to protect basic worker rights on the one hand and the risk on the other hand, if it is set at a too high level, of distorting the labour market and resulting in labour not being employed at all or being diverted from formal to informal employment and a position where it enjoys no legal rights at all.

The Kenyan minimum wage system clearly disqualifies on the first of these grounds. While there may be legitimate reasons to maintain some kind of minimum wage system, the present system should be abolished on grounds of equity as well as efficiency. An argument can be made for a shift away from the present negotiation based approach to minimum wage legislation to a rights based approach, as part of an overall policy package aimed at protecting basic worker rights. A single rate system or a system with two or three rates, differentiating between for instance large cities, other towns and rural areas, but de-linked from occupation, could then be considered. It is beyond the scope of the present study to determine the appropriate level(s) of such a system. However, the present rates for unskilled labour might serve as a starting point. The potential use of, possibly donor funded, public works programmes as a means not only for immediate employment and income generation, but also as an instrument for enforcing a minimum wage would deserve to be considered. Such public works programmes could be undertaken as part of investment in infrastructure, e.g. roads, to be implemented by private or public sector organisations. A provision of employment opportunities at a life-line income corresponding to the minimum wage could help ensure that the market rate for unskilled labour would not fall below the minimum wage level. In a situation where a legal enforcement of a minimum wage throughout the economy is difficult, such a solution might prove more effective.

The collective wage agreements are generally far higher than the present respective wage rates and a cursory assessment also indicates that they in many instances are likely to be above the market clearing rate, and serve to protect the interests of lucky few covered by the agreements at the expense of other workers the required qualifications. They do however at the present cover only a small number of employees, although there may be some spill-over effects on non-unionised work places.³⁹

³⁹ Economic Survey 2005 (2005: 81). In 2004 these agreements covered a mere 46,221 workers.

Furthermore, the effective cost of labour is much higher than the actual wage as a number of fringe benefits, e.g. housing allowances, are part of the negotiated package.

Against the above and the clear indications of a dual formal/informal labour market with poor linkages between the two further investigations into impediments to the creation of a unified and better functioning labour market would be welcome. However, addressing the supply side of the labour market, i.e. the employability and access to employment, will by itself not solve the problem of un- and underemployment. A rapid and sustained increase in the demand for labour, i.e. more opportunities for employment, at levels of productivity and incomes that permit escape from poverty is also needed. Such an increase in employment and income opportunities can only come from enhanced and broad-based economic growth. It is time to turn the focus to the constraints and bottlenecks for achieving such growth.

5 Macroeconomic Policies for Poverty Reduction

5.1 The External Picture

There has been a constant deficit in the trade balance with a cover ratio of export as a proportion of imports ranging from 51 to 66 per cent (Table 13 and 16). However, this deficit seems to be fairly well covered by service flows (tourism, international transport, etc) and current transfers, mainly in the form of private remittances. The current account as a percentage of GDP has fluctuated between -2.9 and 0.5 (Table 13), which should be no cause of alarm, especially since there have been positive entries on 'errors and emissions' in years of negative current account balances. It seems likely that unregistered remittances, which should come in under the current account, form a large part of the positive errors and omission entries.

Table 13. Balance of payments 2001–2004. KSh million.

	2001	2002	2003	2004
Exports	148,592	170,252	184,218	215,982
Imports	254,405	248,766	270,982	342,049
Trade balance	-105,813	-78,514	-86,764	-126,067
Services	22,241	26,185	36,620	54,207
– of which foreign travel	13,016	11,845	16,116	30,645
Net income	-9,524	-11,250	-6,696	-9,057
Current transfers	62,975	49,629	61,985	51,367
– private (remittances)	61,514	47,178	56,884	44,554
Current account	-30,119	-13,950	5,144	-29,550
Capital account	4,043	6,393	12,381	11,495
Direct investments	417	1,591	6,049	3,297
Portfolio investments	-111	-375	-2,862	-5,250
Other investments	23,006	10,101	25,270	8,463
Total capital account	27,355	-2493	40,838	18,005
Errors and omissions	15,836	16,699	-14,597	16,395
Change in foreign reserves	-13,072	-257	-31,385	-4,851

	2001	2002	2003	2004
Memoranda items				
GDP (current market prices)	1,025,918	1,038,764	1,141,780	1,273,716
Trade balance/GDP, %	-10.3	-7.6	-7.6	-9.9
Current account/GDP, %	-2.9	-1.3	0.5	-2.3

Source: Economic Survey 2005 (2005: 135).

Hence, any problems on the external front as reflected in the current account and balance of payments are likely to pertain to the composition of trade and to vulnerability rather than to any serious instability. Tables 14 and 15 give a picture of the composition of imports and exports.

It implies very different effects on the development of the country if imports are composed of investment goods or consumption goods. High and increasing imports of investment goods are an indication of high domestic investments and a dynamic economy. These are imports that will contribute to economic growth and employment creation and, in an export-oriented economy, to higher future exports. High and rising levels of import of consumption goods, by contrast, can be an indication of poor international competitiveness and an indication of an inadequate ability of the domestic economy to respond to domestic demand. This is particularly so if high levels of import of consumption goods are not matched by a high level of export of processed goods. It may also be an indication of a too highly valued exchange rate. The composition of import can also serve as an indication of the depth of the economy. A high share of imports of processed goods raises the question why at least some of these could not be supplied locally and can be an indication of shallowness and poorly developed backward and forward linkages. It is also important to look at the diversity of the exports and imports as an indicator of the vulnerability to terms of trade changes.

Table 14. Structure of imports 2002–2004

	KSh million			Percent		Change
	2002	2003	2004	2002	2003	2002–04, %
Industrial inputs	92,785	92,892	112,936	36.0	31.0	21.7
Investment goods	70,330	59,856	70,650	27.3	19.4	0.5
– machinery etc.	34,704	38,708	51,555	13.5	14.2	48.6
Fuel	47,455	66,297	91,416	18.4	25.1	92.6
Consumer goods	40,622	47,735	58,206	15.8	16.0	43.3
– food	7,375	9,006	10,704	3.0	2.9	45.1
– vehicles & parts	14,853	15,677	21,330	5.8	5.9	43.6
– other consumer goods	18,390	23,055	26,174	7.1	7.2	42.3
Non-specified	7,579	15,058	30,993	2.9	8.5	308.9
All imports	257,710	281,844	364,205	100.0	100.0	32.1

Source: Economic Survey 2005 (2005:130)

Table 15. Structure of exports 2002–2004

Type of good	KSh million			Percent		Change
	2002	2003	2004	2002	2004	2002–04, %
Primary goods	64,285	67,295	75,214	48.9	47.3	17.0
– food	53,358	55,163	60,062	40.6	37.8	12.6
Processed goods	65,547	66,205	77,786	49.9	48.9	18.7
– food products	14,783	14,907	15,009	11.3	9.4	1.5
– other products	50,764	51,296	62,777	38.6	39.5	23.7
Not specified	1,562	3,209	6,061	1.2	3.8	294.4
All exports	131,394	136,709	159,061	100.0	100.0	21.1
Main exports						
Horticulture	28,334	36,485	39,541	21.6	24.9	39.6
Tea	34,376	33,005	36,072	26.2	22.7	4.9
Iron & steel	4,122	4,047	7,532	3.1	4.7	82.7

Source: Economic Survey 2005 (2005: 123, 129)

In Kenya industrial inputs and imports of investment goods made up approximately half of the imports in 2004 (Table 14). The share has increased in absolute terms in recent years, but fallen in relative terms. The falling share of these types of goods in total exports can be explained by the sharp rise in the cost of import of fuel. The bill for fuel import almost doubled between 2002 and 2004. On the positive side was an increase, in both in absolute and relative terms, of import of industrial machinery, which would seem to confirm the picture on the ground that domestic investments are picking up. Industrial inputs account for about a third of all imports (Table 14). Without making any qualitative judgement as to whether his figure is high or not, it does point to the scope for fostering backward and forward linkages in the economy (for instance through sub-contracting) and for replacement of imports by domestic production. Import of consumption goods has increased at a faster pace than overall imports, but still accounted for only 16 per cent in 2004. Vehicles accounted for much of the import of this type of goods. There have been complaints about increasing food imports, not least from agricultural producers, but as can be seen (Table 14) food is only a minor part of imports, even though it has increased somewhat in absolute terms.

The imports are relatively diverse making it less vulnerable to specific price changes on the world market, but oil stands out as an important import item that can have, and indeed has had in the past few years, significant effect on the value of import and terms of trade. Turning to exports, it becomes clear that Kenya is highly dependent on a few export goods, mainly horticulture and tea, and hence highly vulnerable to terms of trade changes and changes in demand (Table 15). Services are another area that is vulnerable due to the dependence on tourism, which in turn can be heavily affected by actions of terrorism and violence. Another big item is private remittances from abroad. Remittances tend to be rather stable and predictable, but may result in a seemingly unwarranted appreciation of the exchange rate and the appearance of a Dutch Disease syndrome as they are rather insensitive to changes in the exchange rate. However, at their present level remittances alone seem unlikely to have such an effect in Kenya.

The capital and financial account can be seen as the source of finance for the current account. Foreign direct investments are positive, but very low (Table 13). There are several reasons for this low interest from foreign investors, which are discussed in the next section on the business climate. Portfolio investments are negative implying that Kenyan capital is invested in monetary instruments and deposited in bank accounts abroad. This is not surprising given the mostly negative real interest rate for saving deposits in the country (see Table 16). The capital and financial account, plus the errors and omissions, cover the current account deficit. The foreign reserves have even increased during the period studied (Table 13).⁴⁰

Kenya had a fixed exchange regime (1966–1982) before switching to a crawling peg tied to a basket of major currencies (1983–1993) and finally to a floating rate in 1993. All foreign exchange transactions are liberalised since 1995. The Central Bank of Kenya has only intervened a few times to influence the exchange rate (3 interventions 1999, 6 in 2000 and one more since then). The exchange rate in terms of KSh per Euro was more or less constant until 2002 when it depreciated significantly. This has been favourable to exporters in Kenya, but imports have become more expensive affecting producers input costs and prices for consumers in Kenya. However, during 2005 the currency has appreciated. The reasons for this appreciation might be the increased inflow of remittances and donor aid, as most other inflows of foreign currency can be assumed to respond to exchange rate changes. If the appreciation continues it will put pressure on the Kenyan producers of export. Their goods will be more expensive in the foreign markets and the imported products on the domestic market will become less expensive.

5.2 The Domestic Picture

Turning to the domestic front, two major concerns can easily be identified. Firstly, there has been a rapid and sharp deterioration of the terms of trade for agriculture, as the prices of agricultural inputs have increased at a much faster pace than the prices of agricultural outputs. Only during the period 2000 and 2004, the terms of trade for the agricultural sector have decreased by more than 20 per cent.⁴¹ This development has inevitably depressed agricultural incomes from an already low level and is also likely to have been a major factor behind the worsening of inequality in recent years. It underscores the need to urgently address the problems of low levels of return to both land and labour in agriculture and the low levels of income in this sector.

Table 16. Selected macroeconomic indicators 2000 – 2004.

	2000	2001	2002	2003	2004
GDP (KSh bn, current market prices)	967.8	1025.9	1038.8	1141.8	1273.7
Gross domestic savings (% of GDP)	6.7	5.3	4.9	6.2	8.1
Gross domestic investments (% of GDP)	17.4	19.2	16.3	17.4	18.3
Inflation** (%)	10.0	5.8	2.0	9.8	11.6

⁴⁰ Negative “change in foreign reserves” means that the amount of money that was necessary to take from the foreign reserves to cover the balance of payment gap was negative, i.e. money was added to the reserve).

⁴¹ Economic Survey 2005 (2005: 145).

	2000	2001	2002	2003	2004
Interest rates (%):					
91-day treasury bill		10.8	8.4	1.4	8.3
Average lending rate		19.5	18.3	13.5	12.3
Average deposit rate		5.0	3.5	1.4	1.0
Spread		14.5	14.8	12.1	11.3
Real lending rate		13.7	16.3	3.7	0.7
Real deposit rate		-0.8	1.5	-8.5	-10.6
Domestic credit (KSh bn)	331.3	334.0	364.9	405.2	472.3
– Government (%)	23.1	26.7	29.8	33.0	27.7
– Private sector and other public (%)	76.9	73.3	70.2	67.0	72.3
Government budget (KSh bn)					
– Revenue and grants	183	216	203	226	271
– Expenditure	175	233	226	264	282
– Capital expenditure****	33	27	34	28	51
Budget deficit (% of GDP)	0.81	-1.66	-2.16	-3.53	-0.93
Public debt (KSh bn)					
– Domestic	206.1	211.8	236.0	289.4	306.2
– External	363.1	366.1	359.4	353.3	443.2
Total (% of GDP)	58.8	56.3	57.3	56.2	58.8
Exports (KSh m)	134.5	147.6	169.3	183.2	214.8*
Imports (KSh m)	247.8	290.1	257.7	281.8	364.2*
Cover ratio (%)	54.3	50.9	65.7	65.0	59*
Current account (KSh bn)		-30.1	-14.0	5.1	-29.6
Foreign exchange reserves (US\$ m)	1398	1459	1614	1888	2138
KSh/US\$	78.0	78.6	77.1	76.1	77.3
KSh/Euro	72.5	69.6	80.8	95.6	105.3
Overall weighted index***	594.2	570.6	622.5	664.0	723.2

* Provisional

** Consumer price inflation (Urban). Average annual inflation.1997 base.

*** Trade Weighted Fisher's Ideal index (SA Rand, TSh, USD, and other exchange rates are included). 1982=100.

**** Capital expenditure by central government. Other government capital expenditures are negligible.

Sources: Economic Survey (2005), Central Bank of Kenya (2005).

Secondly, the large fluctuations in the rate of inflation combined with a rather poorly functioning capital market have resulted in widely fluctuating and unpredictable real interest rates. Inflation has been unstable during the past years and increased sharply at the end of 2004. This was mainly due to bad harvests (increased food prices), increased oil prices and a relaxation of credit policies. The policy change included a decrease in the minimum capital requirement from ten to six per cent and resulted in increased lending, which apparently to a large extent was used for consumption rather than investments. Inflation is now starting to decrease after good harvests in 2005. Generally speaking, the volatility rather than the level of inflation would seem to be the main problem as it spills over in unpredictable real interest rates.

Kenya has an enormous need of capital and investment. The capital stock is outdated, the population is increasing and productivity has deteriorated. Increased foreign direct investments are one important consideration, but there will never be sustained economic growth unless

domestic investments increase as well. Moreover, increased domestic investments are the clearest signal for foreign investors that the business environment is good and stable. As can be seen from Table 16 domestic savings are very low, averaging a mere 6 per cent between 2000 and 2004. At an average of 18 per cent per year, gross domestic investments must also be considered to be much too low to sustain the high rate of economic growth needed to generate sufficient employment and income opportunities and reduce income poverty. This is all the more the case as much of the investment at present is replacement of a capital stock that has been run down during the past decade(s) of economic stagnation, rather than investment in new productive capacity.

The twin problems of widely fluctuating and thus unpredictable interest rate and a large spread between deposit and lending rates have different causes, but both must be addressed to reduce this important impediment to increased domestic investments. The spread between deposit and lending rates has indeed fallen in the past few years to 9.2 per cent in 2004, but would need to be brought down further to a more reasonable 4 – 6 per cent. Bringing inflation under control and, in particular, reducing the fluctuations in the rate of inflation is necessary to ensure more stable and predictable real interest rates. This is essential to make it possible for investors, small and large, to make credible investment forecasts. The real interest rate for loans has fluctuated between 13.7 per cent and 0.7 per cent during 2000 and 2004 (Table 16). Furthermore, efforts should be made to reduce the variety of fees that are associated with taking loans and which can have the effect of increasing the cost of borrowing considerably, in particular for small and medium-sized enterprises. Deposits, by contrast, are very low and when inflation is taken into account it can be seen that real deposit rates have been strongly negative in the past few years (Table 16). This is clearly untenable, as Kenya needs to mobilise savings. It also provides a strong incentive for capital flight, as can be seen from the balance of payment (Table 16). However, there are many other issues related to the costs and benefits of capital formation in Kenya, which are discussed in the business environment section.

By contrast to the two major problems discussed above, Kenya's public debt would at present not seem to be of any major issue of concern. A total public debt equivalent of less than 60 per cent of GDP (Table 16) implies that Kenya is much less indebted than many of its neighbours. The concern in Kenya is not so much the absolute level of public debt, but rather the source of financing and the terms of the debt. As a result of poor access to overseas development funding, the Government has in the past resorted heavily to domestic borrowing and the issuing of treasury bills. This source of funding is not only very expensive compared to accessing overseas development lending at highly subsidised rates, but can have, and arguably has had, the effect of crowding out private lending for investment purposes as the amount of available domestic capital is limited.

5.3 The Public Sector

Revenue collection has improved considerably as against budget from a shortfall of 13 per cent in 2001/02 to a surplus of 8 per cent in both 2003/04 and 2004/05 (Table 17). Meanwhile, expenditures have been contained more or less within the budget during the past few years, resulting in a considerably smaller than planned recurrent deficit than budgeted.

Table 17. Budget outcome as per cent of budgeted.

	2001/02	2002/03	2003/04	2004/05
Revenues	86.9	92.2	108.2	107.8
Current expenditures	105.0	93.0	97.1	101.7
Recurrent deficit	177.5	95.5	67.6	85.7
Development expenditures	55.6	64.4	65.4	83.4
Net external financing & grants	44.6	132	59.1	78.8
Net domestic lending	88.0	55.1	73.1	89.8

Source: Economic Survey 2005 (2005: 103).

Remark: Recurrent deficit equals revenues (excl. grants and loans) minus current expenditures.

Actual development expenditures have consistently been below budgeted, reflecting bottlenecks in implementation. External financing has been highly erratic, but has for three out of the four years been far below budgeted. Shortfalls in external financing have not resulted in unforeseen domestic borrowing, but have throughout the period been covered by a better than budgeted recurrent balance and/or shortfalls in development expenditures. Hence, as a general positive conclusion can be noted that fiscal imbalances have been avoided despite erratic external financing and revenue collection has exceeded expectations in the past two years. On the negative side it must be noted that development expenditures on much needed infrastructure have consistently been disappointing.

Table 18. Government budget as predicted in the PRS. KSh Million.

	2002/03	2003/04	2004/05	2005/06	2005/06
Revenues					
Taxes	182,907	192,237	208,420	231,681	247,310
Non-tax revenues	27,852	36,582	47,486	53,426	63,375
Revenue before grants	210,759	228,819	255,907	285,109	310,689
Grants	15,039	24,108	27,028	22,518	23,357
Total revenues incl. grants	225,798	252,927	282,934	307,627	334,046
Expenditures					
Consolidated fund services	107,478	131,540	118,676	118,699	121,341
– payment of principal	54,453	80,034	74,661	71,686	71,142
– interest payments	38,521	33,472	27,081	27,476	28,010
Discretionary expenditures	212,984	245,813	280,837	289,244	318,456
– Current expenditures	169,654	199,264	216,783	212,556	225,741
– Development expenditures	43,330	46,549	64,054	76,688	92,715
– core poverty programmes	19,487	24,790	27,158	29,332	31,856
Total expenditures	320,461	377,354	399,513	407,943	439,797
Financing gap	94,663	124,427	116,575	100,316	105,751
Net lending need	40,210	44,393	41,916	28,630	34,605

Source: PRS (2004: 17–20).

Remark: Figures for 2002/03 refer to actual outcome. Figures for later years refer to plan as in the 2004 PRSP (adjusted for inflation forecasts) and should not be compared with actual figures reported elsewhere.

As can be seen from Table 18, the PRS (*The Economic Recovery Strategy for Wealth and Employment Creation 2003–2007*) has foreseen a rapid increase in current expenditures and a virtual doubling of the development expenditures between 2002/03 and 2005/06. The increased expenditures were to be funded primarily through an increase in domestic fiscal mobilisation and to a lesser degree through a gradual decline in committed expenditures, that is primarily debt servicing. The need for external net borrowing (foreign and domestic) was foreseen to remain virtually constant, although with a pronounced shift from more expensive domestic borrowing to external borrowing from development agencies at IDA terms or at least subsidised terms. In light of actual performance during the past few years of the implementation of the strategy three main conclusions can be drawn:

- Any fears of over-optimistic forecasts resulting in unforeseen budget deficits have so far not materialised and there would seem to be little reason to worry on this front.
- Erratic donor funding, while clearly a problem, has so far not been overly disruptive as its impact has been cushioned by strengthened revenue mobilisation and at times lower than budgeted expenditures.
- Development expenditures have been disappointingly low and consistently below target. The chief reasons behind this shortfall would seem to be constraints and bottlenecks in implementation rather than financing constraints. This rather dismal performance clearly threatens implementation of the PRS goals and to slow down both economic growth and poverty reduction.

6 Business Environment

Investments in Kenya, foreign as well as domestic, have been exceedingly low and the capital stock is outdated. The involvement of small farms in commercial activities is limited. The number of people active in the informal sector increases but most of them are underemployed and there are no productivity increases. The economy is now starting to pick up, but investments are still very limited and are mainly replacing the old existing capital stock. The question addressed in this section is why, at the margin, there is not more economic activity in the Kenyan economy. Is it a matter of too high costs? If so, what type of costs – the cost of capital or other indirect costs which makes it difficult to do business? Or is it a matter of low benefit from investments? If so, is it a matter of price instability, or of low demand and market access (domestic or internationally)? We also want to look particularly on business restrictions for the poor in their economic activities. When it comes to both high costs and low benefits, are there problems that are specific to the agricultural or the informal sector, or to small and medium size enterprises (SMEs)? Hence, this section will discuss if there are specific restrictions that keeps the economy in general from growing, but also if there are specific restrictions that foster and preserve the structure presented in the previous sections, i.e. if there is a bias in business restrictions against the poor. This economic structure is not only inefficient in reducing poverty, but also in obtaining higher and more sustainable levels of economic growth in general.

6.1 Costs of Doing Business

6.1.1 The price of and access to capital

The cost of finance has gone down over the past few years. It cannot longer be argued that this is one of the major bottlenecks given the other problems listed below, but the cost is still significant and may become a constraint if the real interest rates remain high. The level of non-performing loans is about 28 per cent, which partly explains the high spread in interest rates⁴². Other explanations are low bank productivity, a large number of inefficiently small-scale banks – even though this also prevent cartel pricing, which by some is argued to exist since eight banks control more than 70 per cent of the market – and the difficulty in collecting debt. Moreover, loans are often the only bank activity where profits are of any significance⁴³.

⁴² KEPSA (2005): 17

⁴³ Beck and Fuchs (2004)

A more problematic issue is access to finance, especially for SMEs and small-scale farmers. Only about 6 per cent of the formal SMEs accessed bank loan in 1999, an equal proportion had got credits from other sources, while close to 90 per cent had had no access to credits at all.⁴⁴ The required collateral is estimated at 178 per cent of the value of the loan⁴⁵. Banks refuse to take moveable collateral as security for loans and in most cases only accepts land titles. Given that most agricultural production in Kenya is small-scale, and many of them lack formal land titles, and that the number of non-registered firms in the informal sector has no land titles or formally registered assets at all, this obviously affects the possibilities of business among the poor. An additional problem is that banks and micro-finance institutions have not developed favourable products for small holder farmers and SMEs involved in agro-businesses. The restricted access to credit is also a function of the lack of information on firms' credit rating as there is no public credit rating institution and public registry by which banks can share creditworthiness information, poor legal enforcement of loan contracts and problems with credit collection discussed below. This results in the banks themselves doing the evaluations, which is costly to the banks and restrict possibilities for smaller loans, i.e. loans to the poor, since this cost is fixed.

6.1.2 Tax structure and level

The corporate tax level for residents is 30 per cent and for non-residents 37.5 per cent⁴⁶, which is perceived as too high by many enterprises and an argument for informal firms to stay informal. There is also a perception that the taxes connected to doing business overall are too many and need to be harmonised. The Kenyan Revenue Authority (KRA) has improved its tax revenue collection by more efficient methods and a broader tax base. Revenue collection as a percentage of GDP averaged 21.2 per cent between 2000 and 2003, which is about the double compared to Tanzania and Uganda, but not unduly high compared to developing countries. However, businessmen find KRA to be aggressive in their methods and spend more and more time on tax avoidance, which creates inefficiency in resource allocation, in order to escape the heavy tax burden on the formal enterprises.⁴⁷

The tax treatment of the agricultural sector would seem to be rather favourable. Basic food and all unprocessed farm products (except coffee and tea) are exempt from VAT, as are the principal agricultural inputs such as fertilisers and seeds.⁴⁸ Moreover, farmers are in general exempt from tax registration. However, local authorities level taxes – cess – on farmers as well as on those transporting farm products. The informal sector is not subject to taxes, but the tax system is indeed one of the reasons for its existence.⁴⁹ Hence, simplifying the tax system would improve the possibilities for the poor to join and take part of the benefits in the formal sector. There are already clear benefits from becoming formal, such as possibilities to make your brand visible and marketable, to register patent, to get a formal address, etc). Hence eliminating restrictions would probably be enough for this change to happen. One may also think of other possibilities such as a limited period of tax exemption in

⁴⁴ Micro and small enterprise survey (1999a: 23)

⁴⁵ KEPSA (2005): 16

⁴⁶ KEPSA (2005): 13

⁴⁷ UNCTAD (2005): 29

⁴⁸ Oxford Policy Management (2001)

⁴⁹ However, local authorities are known to level cess on informal firms.

order for informal firms to become formal. Taxes can also be used to specifically target the poor in cases where this does not cause distortions. The government may for example give tax exemptions to, foreign or domestic, companies that establish production in poor areas. The targeted tax exemption for the foreign direct investors in the Export Promotion Zone (EPZ) is going in the other direction since the created cost advantage affects the possibilities for the domestic companies and the poor negatively.

6.1.3 Infrastructure

Lack of or badly maintained infrastructure is a non-disputed bottleneck for further investments and further commercialisation in Kenya, not at least in the rural areas. The state of infrastructure does not only have an impact on the costs of making a specific investment and running a business, but has also a strong bearing on the possible backward and forwards linkages that investments can create. Table 19 gives a picture of the quality of infrastructure compared to some of Kenya's competitors.

Table 19. Quality of Infrastructure (per cent of investors rating quality as "bad" or "very bad").

	Roads/Public works	Telephones	Power	Water
Kenya	91.0	64.5	28.8	67.6
South Africa	6.7	5.0	0.8	1.0
Tanzania	43.6	13.9	26.9	45.6
Uganda	23.5	13.4	47.7	13.2

Source: World Business Environment Survey (2000).

About 72 per cent of the Kenyan manufacturing enterprises rate roads and rail services as either "poor", "very poor" or "not available at all", and as table 19 shows 91 per cent of all investors rate the quality of the roads and public works as "bad" or "very bad". Some 24 per cent of the enterprises report that they spend private resources to improve the roads that lead to their production facilities.⁵⁰ Even the road to the economically crucial port in Mombasa is constantly jammed, but the problems with the roads are even worse in the more remote areas. Another major infrastructure problem is telecommunications. The problems include the quantity (teledensity is low as well as the geographical coverage) and quality of the connections themselves, but also the price of a telephone call and long delays in obtaining a landline connection and in getting in-operational lines fixed. The electricity system has both natural problems (it is based on hydro power and therefore vulnerable to draught) and problems connected to the distribution. This results in many power shortages (corresponding to almost 10 per cent of sales revenues) and a high electricity price. Electricity costs are not only high compared to Asian competitors, but also compared to neighbouring countries. Water and sewage provision is poor if available at all. This is due to under-investments, mismanagement, illegal connections, lack of billing, corruption and destruction of equipment. Some 34 of the Kenyan manufacturers and hotels have dug their own boreholes; others have to pay for extending lines from the main water distribution line⁵¹.

⁵⁰ KEPSA (2005): 9

⁵¹ KEPSA (2005): 10

The poor are the worst affected by infrastructure shortcomings. Improving the roads and thereby lowering the transport costs in the rural area is a prerequisite for the farmers to be able to enter the market at a competitive price, but also for the farmers to buy inputs from abroad or other parts of the country at a realistic price. The fees for using the public utilities are high, especially considering the poor quality of the services provided, and are for therefore reason beyond the means of many poor. Moreover, the fact that private initiatives often are needed in order to access infrastructure – both roads and public utilities – there is also a high fixed costs, which becomes a more significant restriction for SMEs and hence for the poor. There is also a cost connected to the risks of delivery failure, which means that additional private investments, such as in diesel-driven power motors, are often needed to ensure a reliable production.

Infrastructure is to a large extent a public good and the provision is therefore a concern for the government (which does not mean it must or should be managed or owned by the government) if it is to be provided to all or even optimally supplied in an economic sense. In 1994 Kenya started a Parastatal Reform Project including 207 public enterprises in non-strategic commercially oriented enterprises that should be privatised. However, this list did not include larger public enterprises in telecommunication, transport and banking. Recently the Government has agreed with the World Bank and IMF on a programme including 33 public enterprises to be partially or fully privatised.⁵² This will hopefully affect the efficiency of Kenya's infrastructure without imposing too high fees, and public finances that currently are spent covering deficit in these enterprises will be available for other purposes.

6.1.4 Wages and labour productivity

The comparatively well-educated labour force is as mentioned in previous sections an important advantage for the business environment in Kenya, but wages have not developed in accordance with productivity. Wages in the private as well as the public sector have risen significantly for several years, apparently as a result of a strong influence of unionised wage negotiations on the rest of the modern economy and a plethora of non-wage benefits, and possibly also due to increases in minimum wages by the government. Since there has been no improvement in productivity in either sector this affect the cost of labour in the country and the competitiveness compared to other countries. The cost of labour is comparable with other East African countries but significantly higher than the Asian competitors.

The labour cost is not only connected to the wage but also to the fact that firms' are obliged to provide housing and health services for their workers. This is not an efficient system both because it gives the formal firms a heavy cost burden compared to competing firms, and because the restricted size of the formal economy means that most of the Kenyan citizens will be left without this social security net. A direct consequence of these obligations is that the formal firms chose to hire employment on a contract basis or casual labour instead of offering regular employment.

Another problem connected to labour efficiency is that even though workers often have a high level of education, they are often not trained in the skills needed in the Kenyan firms. Many highly educated people benefit from being employed in the informal sector in order to get practi-

⁵² UNCTAD (2005): 58-59

cal experience in order to qualify for formal employment.⁵³ Violence is also affecting the cost and productivity of labour. The Kenyan manufacturing is more or less restricted to one shift production since the employees must return before dark. An option would be to offer home transport, but that would imply yet another labour cost to be added to the effective wage level. Moreover, the HIV/AIDS pandemic will inevitably increasingly affect the supply and cost of labour in Kenya. Kenya has profited from an improving dependency ratio, but this advantage is likely to disappear once more and more people in the working age become sick or die of HIV/AIDS. There is little discussion of HIV/AIDS as an economic problem in Kenya, where it is mainly seen as an issue to be considered in the health sector if considered at all. Any activities connected to employment are private initiatives.

6.1.5 Land

In rural areas there are three main type of land tenure: communal land, government trust land and privately owned land. Communal land ownership is based on traditional customary rights, and all individuals born in that community have a right to use, but not to sell, the land. Government trust land is held by government institutions and intended for public use. Privately owned land gives the owner all the rights pertaining to the use or transfer of the land and it can also be used as collateral to obtain loans.⁵⁴ It has for a long time been government policy to promote privately owned land and individual tenure as the preferred type of land tenure. The intended benefits of a shift to private ownership have been to confer security of tenure through absolute rights of ownership, to encourage investment in land improvement, to make farmers more credit worthy, to create a land market, minimise land disputes, facilitate intensification of agricultural production and increase land productivity.⁵⁵

However, in practice the results have been very mixed. Formal titling of land remains highly incomplete. Together with a poorly functioning legal system and persistent 'indigenous values' this has left many smallholders with very insecure property rights and a strong disincentive to invest in land improvement. Population growth combined with a lack of employment opportunities outside agriculture has resulted in fragmentation of land holdings and landlessness. Women are particularly disadvantaged as in most cases they are not registered in the title deed, rendering their access to other productive assets difficult, and as they often are strongly discriminated against in customary inheritance practices. It seems fair to conclude that a poorly functioning system of land tenure remain a bottleneck for the development of smallholder agriculture. It inevitably discriminates against the poor, who are particularly dependent on strong legal protection of their property rights. It also strongly discriminates against women. It not only makes it virtually impossible for small scale farmers to access credits, but also implies strong disincentives to invest in land improvement, which often is essential to intensify production and increase returns to the land. To this picture should be added another dimension, namely the highly skewed distribution of land. Some 3,600 large holdings control 780 million hectare of arable land, implying an average size of 217,000 hectare, while 3.5 million small

⁵³ Bigsten et al. (2004)

⁵⁴ Strategy for Revitalizing Agriculture 2004-2014 (2004: 5); Rural Development Strategy (2002: 31).

⁵⁵ Rural Development Strategy (2002: 31).

holders on average have little more than one hectare of land.⁵⁶ Not only do the majority of the agricultural households have access to little land, but weak property rights and discriminatory inheritance practices imply that they cannot make maximum use of their land.

In urban areas, too, insecure or non-existent property rights to land are a major problem. Property rights are denied the vast majority of the urban slum dwellers. It can add greatly to the insecurity of informal urban enterprises and also weaken their growth potential as they cannot access credits for lack of collateral.

6.1.6 Price and availability of other inputs

Availability of raw material for production is seldom mentioned as a major constraint for business, but that does not necessarily mean that it is not a problem. Indirect restrictions such as bad infrastructure and trade restriction on imports affect the price of both domestic and imported inputs. Another important factor is the exchange rate, which determines the cost of imported inputs. The rural areas are also in this respect disproportionately affected, both by the high transportation costs compared to the urban area and the effects of price changes on imported inputs in relation to exported outputs. As discussed above, the terms of trade for the agricultural sector has worsened by 20 per cent since 2000, putting a high pressure on farmers' ability to improve productivity and providing a major explanation for the increased inequality in Kenya.

6.1.7 Legal and regulatory environment

Business registration is another non-disputed constraint for further expansion of the formal economy in Kenya. The large number of lengthy procedures results in delays in the establishing of a business, which translates into management costs and opportunity costs, but also in direct costs and bribes. According to a study in 2004 it takes an average of 42 days, which can be compared to 35 in Tanzania and 36 in Uganda, to go through the 12 steps that are needed to set up a company, resulting in an estimated cost for this is about \$220⁵⁷.⁵⁸ In 1998 the Single Business Permit (SBP) was introduced for larger companies in order to facilitate business entry. However, the procedure is managed from the local authority and a manufacturer still has to pay for licences when distributing goods to other areas.⁵⁹

Again, little is done to improve the situation for the main part of the private sector, i.e. the small-scale business of the poor. For example, SMEs are not included in the SBP. The reason for only including larger firms is said to be capacity constraints. Hence, for the small informal enterprise wishing to become formal, the number of licences is still a major restriction. Informal restrictions of entry are also a concern for informal firms that are trying to establish business in self-regulating cartel industries such as the matatu industry. Studies of business constraints in the agricultural sector show that there are over 300 licences, on top of which there are other numerous informal regulations, which affect the transaction cost of commercialising the production. Large firms dominate the export-oriented agro-business, not because it is capital-intensive but because of the need to meet demanding standards.

⁵⁶ Rural Development Strategy (2002: 11).

⁵⁷ Doing Business (2004)

⁵⁸ More recently this time has ostensibly been reduced to 21 days.

⁵⁹ KEPSA (2005): 11

An Investment Promotion Act was newly created offering a guarantee on the investment climate to foreign direct investors. However, this is again a business environment improvement for the larger firms since there is a minimum capital requirement of USD\$ 500 000 in order to be covered by the act⁶⁰. Another problem facing many firms in the informal sector and hence the poor, is the requirement to give details on the business' physical and postal addresses since they often do not operate from a permanent location.

The legislative framework for business activities is fundamental to a working investment climate. As mentioned in the case of land, if people are not able to enforce contracts or legally protect their assets, economic activity will be restricted. Some 74 per cent of investors in Kenya rated the overall quality of the legal system as "slightly bad", "bad" or "very bad" compared to 42 per cent in Tanzania and 43 per cent in Uganda⁶¹. In the case of commercial justice, Kenya struggles with a complex, technical and inefficient system for creating secure transactions and enforcing credit collection, which creates insecurity and increases transaction costs. The procedure of recovering credit through the legal system is costly both in direct costs due to corruption in the courts, and in time costs since there is only one commercial court in Kenya with an estimated backlog of 6000 cases⁶². A non-functioning legal system implies another type of fixed costs that is imposed on firms and which is, as the other costs not related to the production level, especially costly for the smaller firms and hence the poor.

6.1.8 Governance and corruption

Corruption is and have been a major factor affecting the level of investments and the ability to carry out an efficient business in Kenya. Bribes are estimated to cost the firms about 3.8 per cent of sales turnover in manufacturing, compared to 2.4 per cent in Uganda and 1.8 per cent in China.⁶³ Kenya was ranked number 122 out of 133 countries surveyed by Transparency International in 2002 in terms of degree of cleanliness.⁶⁴ This is not a measure of actual corruption but the perception of corruption, which is the relevant indicator when analysing effects of corruption on investment incentives. If investors believe, rightly or wrongly, that a large share of their pay-off will have to be used for bribes, the incentives for investments obviously remain low. It should be a cause of major concern that 70 per cent of the investors rated corruption as a "major" or "very severe" constraint on operations in Kenya in a recent survey⁶⁵. However, the government's Anti-Corruption and Economic Crimes Act is generally perceived as having contributed to improvements when it comes to corruption and there is a bigger resistance among citizens and business men to give bribes.

It is easy to make connection to the former, and to a large extent still existing, system of regulations and corruption. The number of licences needed, the bureaucracy at the borders, the political influence in the private sector, flaws in the procurement system, etc. create opportunities for corrupt activities. By removing these distortions in the economic system the possibilities for corruption would decrease, and by fighting

⁶⁰ UNCTAD (2005): 62

⁶¹ World Business Environment Survey (2000)

⁶² KEPSA (2005): 12

⁶³ KEPSA (2005): 18

⁶⁴ UNCTAD (2005): 44

⁶⁵ Investment Climate Assessment (2004)

corruption the political resistance to reform would decrease. The Kenyan private sector is still very politicised and as long as political connections are needed in order to circumvent flaws in the investment climate, there will not be a functioning free market with an economically efficient resource allocation. The extent of corruption and the need for close connections with the political power is obviously a distortion that is affecting the poor adversely. It seems reasonable to assume that access to political connections is related to income or the size of the firms.

Another concern in the governance area is the under-spending of public finances, which is a paradox given the high expected pay-off from public investments in for instance infrastructure. Lack of finance does not seem to be the main bottleneck to public investments in for example infrastructure, but rather problems with implementation. In the absence of firm evidence, the causes behind this state of affairs must remain a matter of speculation. One reason might be the number of parties in the government. There are in the current government 12 parties that all have programmes of their own and who need to agree on a common agenda. Another explanation might be the relatively immature and not yet fully functioning system of non-corrupt democracy. Neither the citizens nor the politicians have a long experience of democratic communication, but the previous connection and bribe-based system of client-patron communication linger on. Under the new democratic order, the way of getting your voice heard should be to vote for the party the programme of which one prefer, and the way to get votes in order to stay in power should be to be accountable (i.e. provide the promised services and investment) to the voters. Yet another reason might be the current non-competitive procurement system, which provides ineffective deterrents to fraud and inefficiencies.

6.1.9 Crime and violence

Violence, together with bad infrastructure, is the most often mentioned restriction to investments in Kenya, mainly in urban areas. Close to 70% of investors reported having “major” or “very severe” concerns about crime, theft and disorder⁶⁶. One third of the firms in Kenya experienced at least one incidence of theft or arson in 2003. Out of all incidences reported to the police, only 20% are solved. Moreover, there are economic crimes such as fraud, embezzlement, extortion, money laundering, and breach of trust and corruption. The direct economic loss due to crime is estimated to 4% of sales revenue. 82% of firms have invested in private security measures corresponding to 2.7% of their sales revenue.⁶⁷

This is another example where private fixed costs are needed in order to run a business these costs are often not an option for the poor. The result is risky business for the poor since they do not have enough protection. One might argue that the value of the production is lower and hence less attractive to criminals, but criminals also do their calculations. If the possibility of a successful robbery is high as for non-protected SMEs, they can be as attractive as larger companies.

Crime and violence is to some extent a matter of governance, i.e. linked to weak police and judicial systems. However improving these systems means taking care of the symptoms, which might have an impact on the causes but will most certainly not solve the problem. Kenya is, as mentioned, a highly unequal society both when it comes to income levels

⁶⁶ Investment Climate Assessment (2004)

⁶⁷ KEPSA (2005:17)

and opportunities. Only when there are improvements in the incomes of the poor can this, by many seen as the most important, investment constraint be relaxed. A direct action that would improve security is improved infrastructure since a lot of violence and crimes happens along the roads with slowly moving traffic.

6.2 Benefits of Doing Business

6.2.1 Price predictability

The ability to predict with reasonable accuracy the price that the output from a business will fetch on the market is crucial for business planning and investment decisions. Macroeconomic stability is at least at the present not any bottleneck, except that inflation has been volatile and it will take a while before investors gain confidence in the new more stringent macroeconomic government policy. Moreover, since economic growth in Kenya to a large extent is determined by the success of the export sector, the stability of the exchange rate becomes a major determinant of investments.

Even though the domestic economy in Kenya is relatively diverse, this is not the case of export, which is mainly driven by horticulture and tea (Table 15). This makes the export industry very vulnerable not only to fluctuation in the exchange rate but also to fluctuations in the world prices of these specific products.

Lack of market price information or information on market possibilities in general, is a major issue for farmers and an important reason for low marketing incentives. A study of three villages in the highland of central Kenya showed that the most common source of price information is personal visits to the market, field extension services play no role and farmers seem unaware of price information channels through media (electronic and printed)⁶⁸. Rural – urban economic linkages are generally weak and the markets for both farm inputs and produce function poorly. This adds to the cost of operation of in particular small scale farmers and reduces the price of their output, thus squeezing the profitability of small scale agriculture at both ends. In addition, it creates price uncertainty and thus introduces an element of risk which poor farmers operating with very small margins can ill afford. It would seem that the poor distribution and marketing system serving agriculture is at least partly due to a lack of middlemen and intermediaries between producers and consumers of agricultural products. This may in part be due to a general scepticism towards middlemen, which has resulted in a reliance on the government's extension services instead. This would appear to be a chicken and egg problem. A hostile climate for intermediary businesses and middlemen has resulted in a non-competitive market where there are too few middlemen, which gives the existing middlemen the opportunity to set monopolistic prices. Most farmers report that they cannot negotiate on the farm-gate prices⁶⁹.

6.2.2 Foreign demand

The government of Kenya has taken some initiatives in order to facilitate exports. Taxes are, relative to other African countries, low on export manufacturing and even zero for products in the Export Processing Zone (EPZ). EPZ has a number of other advantages compared to the rest of the economy such as exemption from certain licences and higher quality

⁶⁸ RELMA (2001)

⁶⁹ RELMA (2001)

of infrastructure. Another advantage in Kenya is the trade agreements Common Market for Eastern and Southern Africa (COMESA) and East African Community (EAC), and the market access to the European Union (EU) created through the Cotonou Agreement and to the US through the African Growth and Opportunity Act (AGOA). Despite the trend towards more openness, only few firms in Kenya base their production and growth on exports.

The main problem for Kenya to access foreign markets (regional as well as global) is the lack of comparative advantage given costs discussed above, i.e. the industries are simply not competitive enough. However, in the few areas where Kenya does have a comparative advantage in production and transport to the domestic borders, there are still some problems. Customs are for example being accused of focussing excessively on revenue collection at the expense of trade facilitation, and of creating significant delays in export (and import) procedures. Foreign demand is also restricted by political decision in other countries, such as import bans and domestically subsidised production. For Kenya this has been especially connected to EU product standards, which restricts export possibilities. Moreover, the, for Kenya, favourable MultiFibre Agreement that is now abandoned will decrease exports of textiles and clothing as a result.

Considering that agriculture is the main driving force of exports and that exports in its turn is viewed as the main driving force for economic growth, there is amazingly little business analyses conducted on the agricultural market.

It is also important to consider the global trends on the world market with new competitors such as China and other industrialising countries in Asia, taking markets shares and decreasing the foreign demand for the relatively expensive products from Kenya, thus forcing Kenyan producers to operate on increasingly slim margins. Kenyan firms seem to have a slight comparative advantage compared to for example Tanzania and Uganda, but have a significant disadvantage compared to for example China and India. This might compel Kenya to specialise on specific niche products or segments of the global market where price competition is less fierce or on export of services Alternatively Kenya might be forced to focus on more regional markets that are subject to less competition and international standardisation.

6.2.3 Domestic demand

As discussed elsewhere in this study, the very high degree of income and asset inequality implies that Kenya cannot at present depend on broad-based growth of domestic demand as an engine for economic development. The negative and constraining impact on the domestic business environment and business opportunities of the skewed income distribution – where 20 per cent of the population account for close to 60 per cent of the incomes and purchasing power, spending much of it on imports, while 60 per cent of the households combined account for only a fifth of the national purchasing power⁷⁰ – is clearly very severe. The unequal income distribution and the lack of a broad-based demand not only confine the scope for domestic businesses, but also make them vulnerable to market volatility.

However, practices of protecting domestic producers through import restrictions on some products produced domestically have carried a cost

⁷⁰ Pulling Apart (2004)

in the form of reduced efficiency and competitiveness. This can probably partly explain the inefficient agricultural production in Kenya. The major food grains (maize, wheat, rice), milk, sugar, fruits and vegetables, have a nominal protection that ranges from 25 to 100 per cent⁷¹. However, since 2000 imports from COMESA countries are duty free. Not least in the field of agricultural produce there are instances where world market prices are distorted through dumping and producer subsidies in rich countries, making protection of domestic producers perfectly legitimate. However, such instances need to be carefully assessed on a case by case basis. Inward-oriented policies may have contributed to the development agro-business in Kenya in the past, but liberalisation of foreign trade now reveals the lack of competitiveness.⁷²

⁷¹ Oxford Policy Management (2001)

⁷² Oxford Policy Management (2001)

7 Summary and Conclusions

The fact that Kenya is rich in both human and natural resources, has a favourable geographic location, has been free from major conflicts, has a fairly stable macroeconomic environment, etc, but at the same time has a growing unemployment and underemployment and a decreasing capital stock and productivity level, points in the direction of major distortions in the labour market and the business climate. Analyses of the labour market and the agricultural sector shows clearly that migration from the rural to the urban areas is not driven by a structural change in the economy, i.e. by a “pull-factor”, but rather by the lack of income opportunities in the agricultural sector which creates a “push-factor” into ‘distress activities’ in the informal sector. Income opportunities in the informal sector are extremely low as well but there is at least a chance you will be lucky and use it as a stepping stone to more lucrative employment opportunities. Against this backdrop and following from the integrated economic analysis in this study, two major conclusions can be drawn about Kenya’s future growth policies: (i) there is a need for more pro-poor growth in order to increase the income for the very poor, and (ii) several aspects of inequality restrict the potential rate of economic growth in general.

7.1 There is a Need Not Only for Growth, but for Pro-poor Growth

Continued high rates of population growth (2.9 per cent) imply a need for very high rates of growth in order to achieve satisfactory increase in per capita growth in Kenya. The government target of reaching 7 per cent economic growth by 2007 is clearly very ambitious, but necessary. This in its turn will require very high rates of investments. However, the high asset and income inequality implies that the efficiency by which growth will reduce income poverty (the poverty elasticity of growth) is likely to be low. It is therefore unrealistic in the short run to assume that growth will attain such high rates that it by itself will have a satisfactory poverty reducing impact. In order to reach satisfactory rates of reduction of income poverty and to meet the Millennium Goal indicators in these respects fairly high rates of economic growth (at least 6–7 per cent) and a higher poverty reducing impact of a given rate of growth, i.e. a more growth that is more pro-poor than at present will be needed.

A crucial factor affecting the poverty elasticity of growth is the level of distortions in the labour and capital markets and in the business

environment in general. With a flexible economy that adjusts to new economic structure created by growth with a minimum of friction, the need for a focus on a specific group or sector is lower. However, in the case of Kenya there are major distortions, more often than not biased against the poor, in both the labour market and in the business environment that severely impair the possibilities for the poor to seize economic opportunities. It is therefore necessary to look at policies that make growth more pro-poor, in particular by levelling the playing field between small and large and rich and poor actors in the economy.

7.2 Inequality Is a Major Growth Constraint

However, reducing income inequality is not only important to enhance the poverty-reducing efficiency of growth, but a major conclusion from the analysis is that inequality in several dimensions constitutes binding constraints for achieving high and sustainable rates of economic growth. In other words, inequality is a major growth constraint.

7.2.1 Inequality of incomes and assets

- Reducing supply side bottlenecks, important as they are, will not suffice. Sustainable growth has to be demand-led. Although development and diversification of exports and associated issues of international competitiveness is very important, the key engine will have to be domestic demand. At present domestic demand in Kenya is highly skewed. A small urban elite has a large purchasing power. Much of this demand is however diverted to imports and products not produced in Kenya. Meanwhile the purchasing power of the vast majority of the population is very low. In order to achieve a growth that to a large extent is driven by demand, domestic demand has to become much more broad-based. This, in its turn will depend crucially on increasing employment and income opportunities for the poor. Hence, a focus on increasing employment and income opportunities for the population at large would also serve the purpose of making overall economic growth sustainable.
- Security concerns are generally perceived to be a major business environment problem in Kenya and an impediment to investments (domestic and foreign), enterprise development and entrepreneurship. This in its turn is closely related to very high urban unemployment, particularly among the youth, and to income inequality generally.
- Intensification of agriculture, enhanced incentives to invest in agriculture (in particular for poor small holders), major improvements in markets for agricultural inputs and products, improved distribution channels and strengthening of rural-urban economic linkages generally would not only contribute to reducing rural poverty and reduce the push factors behind rural – urban migration, but would also serve to reduce the cost of living in urban areas, thus reducing urban poverty, and indirectly increase the competitiveness of the urban economy through lower production costs. At present, the cost of the bare essentials in life, such as food, would seem to be considerably higher than in many other developing countries – and international competitors.
- More generally, it can be argued that fostering domestic economic integration (rural-urban and not least between the formal economy – informal economy – agriculture) would create larger multiplier effects in the economy and thus enhance growth. It would also reduce the risk of an unsustainable trade deficit as it would permit a shift in the

procurement of industrial inputs from foreign to domestic sources. At present the Kenyan economy is quite shallow, in particular when compared with most Asian developing countries (which in an increasingly globalised world is perhaps the most relevant basis for comparison). Hence, enhancing domestic economic integration would strengthen both the resilience and the growth potential of the economy overall, while at the same time serving the purpose of reducing inequalities.

7.2.2 Inequality on the labour market

High inequality on the labour market, both in the form of high inequality of employability and in inequalities resulting through distortions in the labour market, is another source of economic inefficiency and impairment to growth.

- Kenya has a pronounced dual labour market. On the one hand there is a fairly small but highly regulated labour market comprising the modern urban economy, characterised by comparatively high direct and indirect costs of labour. On the other hand there is a large informal and in practice unregulated labour market comprising the vast majority of the labour force and characterised by low levels of return to labour and incomes and a complete absence of protection of basic worker rights. The linkages between these two labour markets would seem to be very weak indeed. This situation not only serves to entrench inequality in Kenya, but is also highly inefficient from an economic perspective. Firstly, even at modest rates of growth of the modern, formal economy there is a risk of a too rapid increase in formal sector wages (with associated negative consequences in terms of inflation and lost competitiveness) unless there is a sufficient mobility of labour and a sufficiently well functioning labour market to permit an easy flow of labour from the informal to the formal sectors of the economy. Secondly, the duality of the labour market results in gross distortions as relative wages and returns to labour are deprived of their role as an allocating mechanism of labour to the sectors and areas of the economy where the returns are highest. Hence, structural changes in the economy are made difficult and growth is impaired. As a first step to deal with this quite fundamental problem, the current system of labour and wage legislation should be reformed with the aim to shift from the present system a comprehensive regulatory framework covering only the lucky few who belong to the labour market “elite” to a rights approach focussing on providing more basic, but universal, labour rights.
- There is ample evidence of virtually systematic discrimination against women on the labour market. Women are the clear losers on the Kenyan labour market, for reasons that have nothing to do with employability or labour productivity. They are much more exposed to unemployment than men and those employed are often confined to a low employment status and to the low-income segments of the labour market. Quite apart from being deplorable from a gender and a rights perspective, this under-utilisation of half of Kenya’s human resources clearly carries a high cost in terms of forfeited economic development and poverty reduction. This is a cost that Kenya can ill afford.
- There are also severe inequalities in terms of employability. Education is together with health arguably the most important factors determining employability. Kenya has achieved fairly high educational levels, at least compared to its neighbours, but not compared to

peer countries in Asia. However, educational levels as well as access to education remain very unequal. The introduction of free primary education is an important first step to address this problem, which needs to be followed by further reforms aimed at making access to education at increasingly high levels truly universal and fair. One solid development lesson from the fast-growing economies in East and Southeast Asia is that universal education is not a luxury to be provided as and when a country can afford it, but an investment and a prerequisite for rapid, sustainable and equitable economic development. This is a lesson which Kenya would do well to take to heart.

- HIV/AIDS pandemic will inevitably continue to worsen the health status of the Kenyan labour force and population in years to come. Mitigating the socio-economic impact of AIDS, for the individuals and families directly affected as well as on the Kenyan society and economy at large, together with decisive measures to bring down infection rates deserve more prominence in public debate and on the Kenyan policy agenda. More generally, addressing the deteriorating health status of the population, based on the principles of universality and equality, is very much needed not only to reduce human suffering, but also to safeguard Kenya's human resources and economic development.

7.2.3 Inequality of business opportunities

The highly unequal distribution of productive assets obviously implies that the poor are at a disadvantage as entrepreneurs and creators of wealth. Some of these inequalities, notably the distribution of land, may be difficult to address. Other asset inequalities, such as those pertaining to human resources (education, health etc.) are more amenable to rectification and have been discussed above. However, on top and above the unequal distribution of assets, there are also in Kenya pronounced inequalities with regard to the opportunities for making efficient and productive use of the assets at hand. An analysis of the business environment in Kenya clearly shows that there are a large number of impediments and constraints. Most of them imply not only constraints in a general sense, but also clearly discriminate against small and weak actors in the economy.

Among the many constraints and impediments to an enabling business environment in Kenya, the following would seem to deserve particular attention from an equality perspective:

- Protection of property rights. Land and other productive physical assets are not only highly unequally distributed in Kenya, but protection of ownership and user rights of these assets are also generally weak. While those with sufficient resources and influence may be in a position to protect their property rights largely by themselves, the poor and the weak depend entirely on the legal system and on formal institutions for the protection of their property rights. At the present such protection leaves much to be desired in Kenya. Land titling in both rural and urban areas is incomplete and inadequate, affecting primarily small farmers and the urban poor. This not only results in an inability to use fixed assets as a collateral for credit, but as importantly provide a strong disincentive to invest in land and other physical assets. On top of this, rules and traditions regarding inheritance of in particular land severely discriminate against women, constituting a particularly obnoxious form of discrimination. The inability of the

poor to protect their property rights probably deserve to be considered an absolute binding constraint to their full participation in the process of wealth creation and economic development.

- Access to and cost of credit. There are also strong inequalities in access to credit and in the cost of credit. One cause of this inequality is clearly weak property rights and a poorly functioning legal system in the commercial field, making lenders risk adverse and disinclined to lend to the poor. Another cause can be found in the poorly developed and functioning capital market as such, notably the lack of information on credit worthiness which affecting the poor unproportionally. Small loans become non-profitable for the banks given the cost of information. There is also a lack of favourable products for small-scale farmers and small agro-businesses on offer from the banks and the micro-finance institutes.
- Poor infrastructure. The poorly developed and badly maintained physical infrastructure is not only a general bottleneck to growth, but also discriminates heavily against small-scale business and entrepreneurs. It increases the cost of economic activity unproportionally in rural and more remote areas, where the many of the poor live. The need for private back-up systems in the form of own generators, to safeguard against irregular supply of electricity, or own vehicles to compensate for lack of reliable public or private transport facilities implies a high fixed cost for businesses, which puts small businesses at a particular disadvantage.
- The regulatory framework. The large number of licenses and permits required to set up and to run a business and the unduly complicated legal and regulatory framework impose heavy cost on doing business. As most of these costs are fixed and more or less the same irrespective of the size of business, they imply a clear discrimination against small-scale operators. Another aspect of the complex regulatory framework is the scope it provides for rent-seeking and corruption, which also are likely to weight heavier on small scale than on large scale businesses.
- Poorly functioning markets for inputs and outputs. Poorly functioning markets for inputs and outputs is a particular problem in rural areas and for agriculture. It has a negative effect on both profitability and predictability. It makes the procurement of inputs more costly and difficult and the sale of own production much less predictable. It results in high information and transaction costs, which are known to discriminate heavily against small-scale businesses.

All of the above constraints serve to discriminate against small-scale and resource-weak businesses and entrepreneurs through the imposition of high fixed transaction costs and risks. Another related type of constraints pertains to the incentives and possibilities of small-scale informal businesses to become formal. Becoming formal is crucial for the growth of small-scale enterprises since it then becomes visible in the market and gets access to the risk-reducing legal protection. Foremost among these disincentives would seem to be (i) the high cost in time and money of obtaining licences and permits, (ii) the present system of wage and labour legislation and regulations, and (iii) the level and structure of taxation of economic agents. These are all policy-determined constraints and provide a strong case for policy reform.

From the above, it is clear that the priority of the highest immediate order for addressing inequality of business opportunities should focus on levelling the playing field for all actors and at eliminating discrimination against the full participation of the small actors and those with little resources in the economy. These should not imply any costs to the government or any losses of income, except from unproductive rent-seeking. While there are also justifications for more targeted interventions, for instance on remote and poor-stricken areas or on AIDS orphans, such interventions should not detract the focus from the main priority of levelling the playing field. Levelling the playing field would not only reduce unjustified inequalities in business opportunities, but would also help release the vast productive potential of poor people that are presently being grossly under-utilised and thus serve the more general purpose of fostering rapid and sustainable economic development.

The severe inequalities in the economic sphere identified in the present studies as a major obstacle not only for a pattern of economic development that efficiently reduces income poverty, but for economic development as such, have root causes elsewhere in the Kenyan society. They reflect legacies of an unfortunate political system based on patron-client relationships rather than on the principle 'one person, one vote', gender discrimination and inequalities embedded in power structures and social relations. The fact that it is beyond the present economic analysis to address these aspects as well should not in any way be seen as an indication that they are of peripheral or lesser importance. On the contrary, the conclusions from present study underscore that there are strong reasons also from the perspective of economic development to address the non-economic dimensions and causes of inequality in Kenya.

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