CURRENCY AND EQUIVALENT UNITS
(Fiscal Year: July 1–June 30)

Currency Unit = Kenyan shillings
US$ = 67.3 K Sh

Note: All dollar amounts are in U.S. dollars, unless otherwise noted.

ABBREVIATIONS & ACRONYMS

AGO
African Growth and Opportunity Act
MoF
Ministry of Finance
BPO
business process outsourcing
MoH
Ministry of Health
CDMA
Code Division Multiple Access
MTEF
Medium-Term Expenditure Framework
CCK
Communications Commission of Kenya
NEER
nominal effective exchange rate
CMA
Capital Markets Authority
NFE
Non-Formal Education
COMESA
Common Market for Eastern and Southern Africa
DFID
UK Department for International Development
NSSF
National Social Security Fund
EAC
East African Community
NTB
non-tariff barriers
EPA
Economic Partnership Agreement
PCGs
partial credit guarantees
ERB
Energy Regulatory Board
PETS
Public Expenditure Tracking Surveys
EU
European Union
PII
Private Participation in Infrastructure
EPY
proxy for degree of sophistication
PPAF
Public-Private Infrastructure Advisory Facility
FDI
foreign direct investment
PPP
Public Private Partnerships
FTA
free trade agreement
PTR
pupil-teacher ratio
GDP
gross domestic product
RCA
revealed comparative advantage
GoK
Government of Kenya
REER
real effective exchange rate
HPE
high performing economy
SNO
second national operator
ICA
Investment Climate Assessment
SRO
self-regulatory organization
ICT
Information and Communication Technology
SSA
Sub-Saharan Africa
IFI
International Financial Institutions
TFF
Total Factor Productivity
IPO
Initial Public Offering
TIVET
Tertiary, Industrial, and Vocational Education and Training
ITA
Information Technology Agreement
TKL
Telkom Kenya Limited
KNB
Kenya National Bureau of Statistics
UNDP
United Nations Development Programme
KPA
Kenya Ports Authority
VAT
Value Added Tax
KPLC
Kenya Power and Lighting Company
VoIP
Voice over Internet Protocol
KRA
Kenya Revenue Authority
WDI
World Development Indicators
LDC
least developed country
WHO
World Health Organization
MDGs
Millennium Development Goals
WTO
World Trade Organization
MFN
most favored nation
MoE
Ministry of Education

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The report draws upon the following background papers/notes prepared toward the growth analytical work to inform Vision 2030 of the Government of Kenya (GoK 2007b).

1. “Kenya’s Quest for Growth—Stabilization and Reforms—But Political Stability?” Authors Luca Bandiera, Praveen Kumar, and Brian Pinto
3. “Kenya: Growth Diagnostics.” Authors Njuguna Ndungu, Praveen Kumar, Leonardo Garrido, and John Randa
5. “Efficiency of Government Education Expenditure in Kenya.” Task Manager Carla Bertoncino

Background papers/notes can be obtained by sending an e-mail to daharris@worldbank.org. This report may contain more updated information than in the background papers.
The findings of the background papers were informally shared with the Ministry of Finance and the Ministry of Planning and National Development to inform the ongoing development of Vision 2030 document, as well as the central government's budget for the fiscal year 2007/08. The team made a presentation to GOK officials at the end of its mission in February 2007.

Apart from the papers above, the report draws upon the World Bank Investment Climate Assessment carried out in 2007, which has been finalized in parallel as an independent report.

The work on roads was funded by DFID through a trust fund which is gratefully acknowledged.
FOREWORD

(a) This report was prepared mostly in 2007, with January 2008 as the original delivery date.

(b) While the reference point is Vision 2030, the report focuses on what needs to be done in the next five years to realize a significantly higher growth potential and sustain high growth. It is therefore largely relevant to alternative time lines for implementing the Vision.

(c) The report has not been updated to take account of developments from late December 2007 through March 2008. However, the main messages of the report relate to structure of the economy, which remains largely unchanged. Therefore, these messages remain relevant to achievement of growth objectives of the new government.

(d) If anything, the messages are even more relevant. The impact of postelection incidents on the economy demonstrated the importance of political stability for growth, a key message of this report. Similarly, this report highlights the importance of addressing the ethnic fractionalization and income inequality as components of a long-term growth strategy, a message that again rings true. For sustaining growth over a long term, it is not enough to return to the precrisis growth path; rather, Kenya must reduce the risks of a recurrence of the problems highlighted by the crisis.

(e) The report is part of a suite of analytic pieces being completed by the World Bank Group, including the Poverty and Inequality Assessment, Investment Climate Assessment, and Corporate Governance Report on the Observance of Standards and Codes (ROSC), which complement this work with insights into how Kenya might achieve higher and more inclusive growth and accelerated poverty reduction.

(f) The international community is seeking opportunities to work with the coalition government to accelerate economic growth, intensify poverty reduction, and promote economically, socially, and environmentally sustainable development. The report in its current form remains relevant to this effort, as well as to the medium-term plan of the government.

(g) The report was shared with the GoK in May 2008. In addition, it was presented to stakeholders within the GoK on July 8, 2008. This was followed by a public launch of the report to the media and other stakeholders outside the government on July 9, 2008.
EXECUTIVE SUMMARY

A Focus on Inclusive Growth in the Next Five Years

This report focuses on what needs to be done in the next five years to realize a significantly higher growth potential and sustain high growth in Kenya. The challenge before Kenya and the new government is to take the economy to the next phase of development.

Experience from all over the world shows that growth is central to all strategies for reducing poverty and creating jobs. This has been Kenya’s experience as well. During the 1990s, lack of growth coincided with increase in poverty and decline in human development indicators. However, these trends were arrested, or even reversed in some cases, with the ignition of growth after 2002.

The central message of this report is that despite the recovery, the economy is not yet at a stage of development where higher or even recently achieved growth rates—around 6 percent per year—can be safely assumed. Serious bottlenecks to investment—and thus to growth—continue. Infrastructure services remain costly and unreliable. Institutions at a microeconomic level, such as those dealing with trading across borders and providing security, are not efficient and do not deliver effectively. The government has not managed to make a major dent in the problem of corruption. Above all, despite being better developed relative to regional neighbors, the economy is underdeveloped relative to faster growing economies in the world with which Kenya should compare itself.

The Critical Importance of Reducing Business Risk by Maintaining Political and Macroeconomic Stability

To achieve higher growth in Kenya, and to reduce poverty and generate jobs, two preconditions are critical: low political and macroeconomic risk. Political and macroeconomic stability initiated and fueled growth recovery in the past five years (see chapter 1). They will also be essential for future growth, poverty reduction, and employment generation.

The sources of political risk or instability are many. These include uncertainty over the course of future policy, corruption, and the importance of political connections to doing business. The December 2007 elections have highlighted additional sources of political risk in Kenya—ethnic and social tensions with roots in inequality.

In particular, the experience of the past five years has demonstrated that growth in Kenya is very sensitive to perceptions of political and macroeconomic risks. If political risk is high, businesses will make fewer new investments. In the absence of macroeconomic stability, economic uncertainty will tend to increase—and with it, expectations of rising inflation and interest rates, which will slow down private investment and growth.

To sustain growth over a long term, it would not be enough to return to the precrisis business environment; additionally, Kenya must reduce the risks of a recurrence of the socioeconomic problems that contributed to the crisis.

This report offers some steps to help maintain macroeconomic stability through fiscal policy for growth. Upcoming work by the World Bank on poverty assessment addresses some of the
distributional issues that must be addressed to reduce political risk from social tensions. This report focuses the bulk of its analysis on the question of removing constraints to growth, particularly in the form of rapidly improving total factor productivity (TFP). Kenya has considerable scope for enhancing productivity by reducing business costs. These can be seen as “low hanging fruits”: relatively easy improvements that can yield large results in the next few years. Improved integration with the global economy through trade and investment would provide other sources for TFP enhancement. These steps can trigger a virtuous cycle leading to higher growth: including further improvements in investments—both domestic and foreign—improved productivity, greater competitiveness, and increased international trade.

In particular, the report examines the following areas more fully:

- Pursuing fiscal policy to promote growth including steps to mobilize private resources for infrastructure.
- Steps to improve transport and telecommunications services and reduce their costs.
- Steps to accelerate global integration.

This report reinforces the findings of the Vision 2030 document in several areas, adds value in many others, and modifies some. Most significantly, this report agrees with the Vision that tourism, manufacturing, and service sectors based on information and communication technology (ICT) are likely engines for growth. However, this report is much less emphatic than Vision 2030 about the sectors (identified winners and flagship projects) on which government should focus for delivering the aspired growth. The emphasis of the report is instead on generic economy-wide reforms aimed at reducing business costs and improving productivity. A sector/industry lens is supported to address only sector/industry specific binding constraints to growth. This shift in emphasis has large implications for policy. It frees up the resources of the state—financial resources, as well as the time and effort of policymakers—to focus on generic reforms rather than implement and follow-up elaborate grand sector strategies.
Box 1: About this Report

This report attempts to answer a major question faced by policymakers: if political and macroeconomic stability are maintained, what more would be needed to accelerate and sustain growth in Kenya. The answer to this question lies in understanding the constraints to accelerating and sustaining growth. Empirical work shows that constraints to accelerating growth at a particular time (proximate constraints) may differ from constraints to long-term sustained growth (deeper constraints). Therefore, this report carries out analysis towards understanding constraints to growth at three levels. First, a benchmarking exercise is carried out, comparing Kenya with successful economies, to highlight areas where Kenya would need to make deeper efforts to achieve sustained growth. Second, a growth diagnostics exercise is carried out to understand the nature of binding constraints to accelerating growth in the medium term. This exercise asks why the investment rate is low in Kenya. Finally, a macroeconomic perspective is developed to look at the feasibility of a very high growth rate—such as 10 percent envisioned in the Vision 2030. These analyses are then combined to propose a strategy for accelerating and sustaining growth.

In its analysis, the report draws upon the state-of-the-art thinking on the issues of growth, which is going through considerable rethinking among economists and practitioners. Among several departures from the conventional view, the new thinking shies away from providing prepackaged answers to an economy’s problems and emphasizes country-specific analysis instead. Similarly, the focus has shifted from identifying correlates of growth at a macroeconomic level (as in growth regressions), to identifying constraints to growth at a microeconomic level. This report reflects this shift in thinking and draws mainly upon analysis specific to Kenya (such as growth diagnostics and the Investment Climate Assessment, ICA) to arrive at conclusions relevant to policy choices. We would hope that the approach and methodologies of this report influence future thinking about growth issues in Kenya.

Deep Determinants of Kenya’s Long-term Growth

The analysis underlying this report yields the following major conclusions:

**Kenya has a number of strengths when it comes to potential for high long-term growth compared to sustained growth economies in other parts of the world.** Kenya has developed a skilled, English-speaking labor force. Kenya’s natural beauty and coastal location provide unexploited potential. Policy choices have evolved in the right direction in Kenya (see Figure 1). The structural reforms carried out during the past two decades have positioned Kenya well to exploit the potential offered by geography and skilled labor through private sector-led development strategy. Continued structural reforms aimed at strengthening the country’s external orientation and the role of the private sector should further advance Kenya’s prospects.
Figure 1: Macroeconomic stability has been achieved through fiscal reforms and discipline

Source: Staff calculations, based on data from Kenyan authorities, IMF Staff Reports, and World Bank.
Note: Domestic debt is net of government deposits in the banking system and on-lending. External debt is on a gross basis and includes borrowings from the IMF.

In terms of political and broad economic institutions, Kenya's position is mixed. It does well on international indicators of institutionalized constraints on executive decision-making. However, the recent political crisis has highlighted the inherent weakness of institutions to ensure smooth political transition in a democratic context. Kenya ranks much lower on control of corruption, even compared to fast-growing Sub-Saharan African (SSA) countries (see paragraph 2.33). Finally, income inequality is relatively high. Research shows that high inequality in incomes can be inimical to growth.

Kenya is significantly disadvantaged on measures of social fractionalization (ethnic, religious and linguistic), compared to sustained growth countries, and is disadvantaged even compared to fast-growing SSA economies (Table 1). Globally, there is evidence that social fractionalization affects economic outcomes and hurts growth due to ethno-regional biases in policy, particularly the provision of public goods, and indicates a higher potential for conflict and derailing growth.
Table 1: Kenya ranks worse on measures of social fractionalization than sustained growth countries and other fast-growing Sub-Saharan African countries

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Sustained growth countries, average</th>
<th>Fast-growing SSA countries, average</th>
<th>Kenya</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ethnic&lt;sup&gt;a&lt;/sup&gt;</td>
<td>0.30</td>
<td>0.72</td>
<td>0.83</td>
</tr>
<tr>
<td>Ethnic&lt;sup&gt;b&lt;/sup&gt;</td>
<td>0.33</td>
<td>0.75</td>
<td>0.85</td>
</tr>
<tr>
<td>Religion&lt;sup&gt;b&lt;/sup&gt;</td>
<td>0.30</td>
<td>0.53</td>
<td>0.70</td>
</tr>
<tr>
<td>Ethnic&lt;sup&gt;c&lt;/sup&gt;</td>
<td>0.32</td>
<td>0.68</td>
<td>0.86</td>
</tr>
<tr>
<td>Linguistic&lt;sup&gt;a&lt;/sup&gt;</td>
<td>0.29</td>
<td>0.76</td>
<td>0.89</td>
</tr>
<tr>
<td>Religion&lt;sup&gt;c&lt;/sup&gt;</td>
<td>0.42</td>
<td>0.54</td>
<td>0.78</td>
</tr>
</tbody>
</table>


Note: A higher value represents higher fractionalization.


Finally, Kenya’s integration into the global economy needs to accelerate, building on recent success. The extent of a country’s external orientation is a significant determinant of long-term growth, evidence from other countries demonstrates. Kenya does not look much different from sustained growth countries at the beginning of their growth acceleration, in terms of level and structure of exports. However, exports of sustained high growth countries surged dramatically following a period of improving competitiveness as growth accelerated (Figure 2). Kenya’s exports have started showing dynamism only recently, despite remarkable success in some areas, such as horticulture.

Figure 2: Kenya should improve its competitiveness (in terms of rising shares of world exports) if it wants to emulate high performing economies (HPE) at the beginning of their growth acceleration.

![Figure 2](image)

Source: Staff calculations, based on COMTRADE data. Averaged using SITC2 3-digit classification.

Note: HPEs include Ireland, Botswana, and Mauritius, in addition to sustained growth economies. Sustained growth economies are Chile, China, Dominican Republic, Egypt, Indonesia, Republic of Korea, Malaysia, Singapore, Taiwan, Thailand, Tunisia, and Vietnam.
Binding Constraints to Accelerating Growth in the Next Five Years

Investment is low in Kenya for two broad reasons. First, returns to investment are low and risks to appropriation of returns by private investors are high. Second, access to finance is limited and costs are high for certain categories of borrowers, such as rural and small entrepreneurs. Returns to investment are low, in turn, mainly because business costs other than the cost of labor and capital are high. These include the high cost and unreliable supply of infrastructure services, particularly transportation and energy, as well as opportunity costs due to logistics bottlenecks, such as delays of shipments and trading costs at the border. Risks due to corruption and the security situation remain serious deterrents to investment.

The high costs of business have reduced Kenya's global competitiveness in tradable goods and services. The extent of loss of competitiveness is highlighted in Table 2, which compares Kenya with a number of countries. To these costs must be added opportunity costs of delays due to logistics bottlenecks. Largely because of these costs, Kenya is rated low on various cross-country indexes of global competitiveness.

Table 2: Costs of crime, security, bribes, and lost production are several times higher in Kenya than in other countries

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Production lost due to crime</td>
<td>3.9</td>
<td>0.3</td>
<td>0.2</td>
<td>0.6</td>
<td>1.0</td>
<td>1.1</td>
<td>1.0</td>
</tr>
<tr>
<td>Payment for security</td>
<td>2.9</td>
<td>0.8</td>
<td>1.3</td>
<td>0.9</td>
<td>1.5</td>
<td>2.3</td>
<td>1.4</td>
</tr>
<tr>
<td>Bribes</td>
<td>3.6</td>
<td>1.9</td>
<td>2.1</td>
<td>0.3</td>
<td>0.4</td>
<td>3.4</td>
<td>3.7</td>
</tr>
<tr>
<td>Production lost in transit</td>
<td>2.6</td>
<td>1.2</td>
<td>0.8</td>
<td>0.8</td>
<td>n.a.</td>
<td>1.6</td>
<td>1.2</td>
</tr>
<tr>
<td>Production lost due to power outages</td>
<td>7.1</td>
<td>2.0</td>
<td>7.8</td>
<td>0.9</td>
<td>5.1</td>
<td>10.7</td>
<td>10.2</td>
</tr>
<tr>
<td>Total costs</td>
<td>20.1</td>
<td>6.2</td>
<td>12.2</td>
<td>3.5</td>
<td>n.a.</td>
<td>19.1</td>
<td>17.5</td>
</tr>
</tbody>
</table>

Source: ICA 2007
-- not available

The tax burden (including fees and levies) is perceived to be high. Experience elsewhere suggests that negative perceptions about the tax burden could be rooted in unreliable and costly public services. Given these perceptions, further analysis is needed to establish if tax levels constrain new investment or otherwise create large distortions.

Investment by smaller businesses could be constrained because of poor and costly access to finance. One reason for these perceptions appears to be the high cost of collateral requirements in Kenya. Informal businesses also have greater problem in accessing credit. Access to credit declines as one moves from urban to rural areas and is the thinnest in arid areas.

A Macro Perspective on the Feasibility of Vision 2030’s Goal of 10 Percent Growth

Vision 2030’s goal of 10 percent long-run growth is ambitious, considering that Kenya’s average annual GDP growth rate was around 3 percent from 1980 to 2005. To put the goal in an international perspective, only ten economies with population greater than 1 million achieved an average per capita growth rate higher than 4 percent from 1980 to 2005. Only China was able to achieve an average growth rate of about 10 percent during this period.

For the long-run high growth rates that Kenya aspires to achieve, it will be necessary to make strong long-run progress along multiple fronts, according to the analysis carried out for
this report: raising growth of total factor productivity (TFP); attracting foreign direct investment (FDI) and foreign aid; and mobilizing domestic savings.

To accelerate growth, rapid improvement in total factor productivity (TFP) will be critical. Reducing business costs and improving integration with the global economy through trade and investment would provide sources for enhancing total factor productivity. A target contribution of about 2 percent to overall growth by TFP growth could provide a reasonable challenge. In comparison, TFP growth contributed 1.8 percent per annum to the per capita growth rate during 2003-06.

To support capital accumulation, there is considerable scope for greater use of foreign savings, in the form of foreign direct investment and remittances (Figure 3). Kenya’s private savings rate is relatively low and is expected to improve slowly. A rapid increase in private savings rate would require an initial slowdown in the growth of personal consumption. Therefore, foreign savings in the form of foreign direct investment (FDI) could help relax the domestic savings constraint, especially in the beginning of the period of growth acceleration.

Attracting foreign direct investment is especially important. FDI would bring with it newer technology and newer products and help improve productivity, as happened in the horticulture and garments sectors. Indeed, Kenya is likely to rely considerably for its productivity growth on technological change embodied in new investment. Lastly, FDI is likely to be a source of access to other markets, particularly in niche products, as has happened in East Asia. FDI would increase as the public infrastructure, crime, and security situation improve.

Figure 3: FDI is miniscule and aid flows also have stagnated and remain at a low level

![Graph showing FDI and aid flows]

Source: WDI database, World Bank.

Flows of foreign aid could go up, as well. They have been stagnant at around 3 percent of GDP in the past five years. Improvements in governance and investment climate, combined with initial signs of success, have the potential to convince aid providers that additional aid would be put to good use. Kenya should work with aid providers to ensure that transaction costs of aid are low, that aid is predictable, and that it goes into priorities for growth and poverty reduction. Too much aid going into the services sectors would likely impede efforts to maintain a competitive real
exchange rate. The trick would also be to ensure that foreign aid does not dampen revenue efforts. The caveat about the revenue effort is important because a low level of aid appears to have motivated fiscal reforms in Kenya in 1990s.

A Recommended Growth Strategy

Assuming continued macroeconomic stability and that Kenya can keep political risk low, the growth strategy should focus on relaxing other constraints to accelerating and sustaining growth.

To accelerate growth, attention should be paid to reducing the cost of transportation services including logistics and telecommunication services, and improving the reliability of energy supply; reducing the costs and risk that stem from inadequate security and corruption; and improving access to finance to small and rural entrepreneurs.

Reducing business costs would improve productivity. It would also enhance international competitiveness and thereby improve Kenya's integration into global economy. Additional policy actions could support faster integration into the fast-growing global economy.

The discussion that follows drills down into selected elements of the growth strategy outlined above. Some elements are not covered by this report; these are policy issues in the energy sector, access to finance issues, and reducing corruption and improving security. Some areas need future analytical work. These are discussed in Chapter 1.

Pursuing Fiscal Policy with Growth Objectives

Kenya appears to have some fiscal space for increased infrastructure spending. The goal of fiscal policy in the next five years should be to “expand fiscal space” for infrastructure and social spending (to accelerate attainment of the Millennium Development Goals) without compromising the solvency of public finances. To this end, Kenya should:

Tap concessional resources for high return projects. Largely untapped concessional resources should be used effectively to meet infrastructure needs. Taking on any nonconcessional financing (such as Eurobonds) should be explicitly linked to projects with unquestionably high rates of return.

Improve the institutional mechanism for selecting high-return projects. Currently, there does not appear to be a systematic process for identifying capital projects based on economic analysis. There is ambiguity about the respective roles of the Ministry of Finance (MoF) and line ministries on individual project selection. An institutional mechanism should be established for developing a pipeline of high-return projects using consistent cost benefit analysis and project appraisal techniques. The MoF should also issue standard project identification and appraisal guidelines, supplemented with sector-specific guidelines for demand and benefit measurement.

Improve the efficiency of public spending. Kenyan policymakers have long been sensitive to the need to improve value for money. The current government has focused attention on results, which aims to improve outputs for a given level of inputs. The prime sectors for attention to efficiency are education, health, and roads, since these sectors are important to human and physical capital accumulation and hence long-run growth, and are the biggest public spenders.
Box 2: Improving Value for Money in Education, Health, and Roads

In the **education sector**, the fiscal challenge is to finance the ongoing expansion of education on a sustainable basis and maintain or improve quality of education outcomes. The principal challenges are to improve completion at primary school, increase enrollment in lagging regions, and increase opportunities to go on to study at secondary school without damaging quality. Efficiency gains and targeted policies will be required to keep within the medium-term resource envelope, which remains reasonable at 7 percent of GDP. Solutions will primarily come from improving the use of teachers, making the most of nonformal, nonpublic providers, reducing repetition, and improving accountability for household expenditures.

In the **health sector**, improving efficiency and effectiveness of public sector spending is of paramount importance. The challenges include improving management and accountability for public funds and health results, regulation over private sector provision, and increasing the rate at which donor and government commitments turn into actual spending and service delivery. There is scope for improving efficiency of hospital-provided curative services—which constitute around half of government’s health spending—by strengthening financial management. Greater use of district hospitals could lower overall unit costs of hospital care. There is scope to rebalance staff to address shortages and improve productivity; to improve efficiency in drug and medical supplies; and to improve budget utilization considerably through decentralizing.

In the **roads sector**, priority policy actions to improve value for money have been identified; now they need to be implemented. They include: improving planning and preparation of projects; choosing projects with high rates of return; adhering to good procurement procedures and practices; and strengthening of supervision, monitoring, and evaluation. Putting the new institutional structure in place would help, but the government attention should remain firmly focused on the above objectives.

**Encourage the inflow of remittances.** Remittances have reached up to the level of 5 percent of GDP in the past. While a large part of the remittances generally finance consumption, remittances could finance investment directly or could lead to increased private savings. The government could explore innovative instruments such as diaspora bonds to attract higher savings from the Kenyans living abroad (see Chapter 6).

**Improve the enabling environment for Private Participation in Infrastructure (PPI), to leverage public resources with the private resources.** Kenya’s experience with private investment in infrastructure from 1990 to 2007 has been mixed. There are examples both of outstanding success (in telecommunications) and of failures (in power and port projects). This experience has yielded several lessons. First, overall, Kenya has followed an unstructured approach to PPI. Developing institutional support for public-private partnerships (PPP) to implement transactions in a transparent and effective manner should be a priority. Second, an effective regulatory regime is important to mitigate risk to private providers, especially in the energy sector and transport sector. Third, local capital markets should be developed. Finally, it is important to manage the politics of PPP. The unsuccessful privatization of Mombasa container terminal is an example where political considerations have delayed a good economic decision. Confidence and trust can be built by involving stakeholders, maintaining transparency, and generating quick results.

**Establish adequate institutional arrangements for project analysis, negotiation, implementation, and monitoring of PPP transactions.** Well-defined institutional arrangements such as competitive bidding, clear bid evaluation criteria, disclosure of winning bidder and the bid price, and putting the transaction agreements in public domain to provide oversight are also needed to make the process transparent. The government can demonstrate its commitment to PPP by publishing a policy in the National Gazette. The government should consider establishing a
PPP Secretariat in the MoF and use it to evaluate PPP undertaken by line ministries. In the interim, the MoF should take stock of all large PPP that are in the procurement stage to ensure that such deals are both affordable and do not result in a level of financial exposure that is unacceptable.

**Steps to Improve Transport and Telecommunications Services**

**Improve the efficiency of the Mombasa port.** This is the single most important step that policymakers could take to improve global competitiveness. The port is critical to reducing logistics costs and increasing opportunities for Kenya to participate in global production chains. Despite ongoing reforms, the Mombasa port is plagued by inefficient handling of containers and bureaucratic procedures, resulting in long waits and dwell times. The government should give priority to completing the ongoing modernization program of the port, including moving to a computer-based system to organize and manage container stacking and storage. The government should implement the decision to convert the Kenya Ports Authority (KPA) into a landlord port authority. It should also separate the commercial and regulatory functions, and put commercial operations into the private sector through concessions.

**Give priority to the rehabilitation, and routine and periodic maintenance, of the existing classified road network.** Kenya has an extensive road network. However, among the main trading routes, many roads are in less than “good” condition, which raises costs and hampers Kenya’s competitiveness. Rehabilitation of the existing classified network to a maintainable level should be a top priority. Decisions to expand the capacity of the existing roads or the road network should be made only based on rigorous cost-benefit analysis, which has not routinely happened in the past.

**Implement and monitor logistics reforms as a package, since the weakest link in the supply chain can act as a bottleneck for the entire chain.** Reducing wait time at the port, weighbridges, and borders is at least as important as expanding the capacity of existing roads, from a trade logistics point of view. Similarly, giving priority to rehabilitating certain sections of roads, such as those that are acting as a bottleneck to off-take from the port, would yield high benefits. A set of logistics indicators should be developed to benchmark reforms and progress (see World Bank 2007a). The private sector should occupy an important role in driving forward reform, as well as in some advisory capacity.

**So the economy can benefit from lower costs and more reliable telecommunications services, quickly implement plans to connect to a global fiber optic cable through any of the current projects (such as EASSy and TEAMS).** This is particularly important if Kenya is to develop a competitive advantage in newer telecommunications products. The lack of affordable international backbone bandwidth is a major constraint to improving productivity across the economy, and probably the biggest obstacle to the development of the business process outsourcing (BPO) and other ICT-related industry. Continued liberalization in the sector will reduce costs further. The fixed line market is one of the most restricted. Introducing a Second National Operator (SNO) and a third mobile operator, as well as and privatizing the remaining shares in Telkom Kenya Limited, offer considerable opportunities to improve services through increased competition and technology transfer. Bringing down the prices of mobile phones handsets and calls will help extend coverage and boost Kenya’s competitiveness. Kenya should also consider joining the optional WTO Information Technology Agreement (ITA). This could reduce the cost of ICT inputs to businesses by binding Kenya to eliminate customs duties on major information technology products.
Steps to Increase Global Integration

Deepen regional integration within the countries of the East African Community (EAC). Kenya's exports to neighboring countries have expanded in the past few years. Regional trade will therefore remain important. Deepening of regional integration is also desirable because regional trade helps in integrating fragmented markets, allowing economies of scale and helping in developing new exports to third markets.

Push into expanding trade with middle- and high-income countries (Figure 4). Kenya should use its membership in trade groups—EAC and COMESA—to consolidate further trade openness, rather than secure trade-diverting preferences. In areas where Kenya cannot move speedily enough through these trade groups, it should liberalize unilaterally, with an eye on global competitiveness beyond the borders of regional partners. In addition, Kenya should continue its efforts to secure access to markets outside the region, particularly in Asia. Kenya has recently signed an interim Economic Partnership Agreement (EPA) with the European Union (EU) jointly with its partners in the East African Community. Kenya will need to continue negotiations with the EU in 2008 for a full EPA and participate effectively in multilateral negotiations. The multilateral route may be the best way to negotiate market access to dynamic Asian markets, where Kenyan products face high tariff barriers.

Figure 4: Kenya needs to expand its trade with middle- and high-income countries (percent of total trade)

Use an industry-wide or sector focus to address micro-constraints faced by the private sector in key areas of export growth. This is the approach taken by Vision 2030. The Vision identifies manufacturing, high-valued services based on Internet, and tourism as areas where a sector/industry lens could prove useful. Horticulture and tea sectors are good examples where government provided helpful nonfinancial support. Similarly, the National Export Strategy Implementation Action Plan 2005 (GoK 2005a) developed a list of sensible policy actions to support various products and subsectors. (See Chapter 4 of this report for actions in the Information and Communications Technology (ICT) sector, and Appendix G for preliminary findings of an ongoing World Bank study on tourism.) Generally, the objective of government involvement would not be to provide financial support or make public investments, but to try to identify sector-specific issues—such as government/market failures—and provide solutions, in
close dialogue with industry groups and associations, to recover, maintain, or improve Kenya’s competitive position.

Maintain a competitive real exchange rate. Many of the policy actions discussed in this executive summary would help keep the real exchange rate competitive. For example, an improvement in productivity in the services sector through reduction of costs would help maintain competitiveness. Similarly, further trade liberalization would help through increased imports. The report would caution against active attempts to manage the nominal exchange rate. More analytical work needs to be done to identify other policies that could help in maintaining a competitive real exchange rate.

A Strong and Positive Role for Government

The growth strategy presented in this report implies a strong, positive, and enabling role for the government.

- **Improving the investment climate and adopting appropriate trade policy to enhance competitiveness** is largely in the domain of the government. The government has made a good beginning in identifying regulatory hurdles and streamlining administrative processes faced by the businesses. Substantial and lasting benefits will accrue only if these reforms are deepened. Some sectors could also benefit from sector-specific policy actions.

- **Managing public finances to create fiscal space for social spending and infrastructure spending** without compromising the solvency of public finances is government’s job. The challenge before the government is to put a system in place for selecting projects and programs with high rates of return and improving the efficiency of spending in the ministries of education, health, and roads.

- **Pursuing an implementation/results orientation in the public sector** would be critical to success of the growth strategy. The government has been successful in the past two years in improving focus on results. Yet an inordinate amount of government time continues to be devoted to preparing and discussing comprehensive strategies and plans. While short and sharply focused studies may be needed in some areas, attention should shift to implementing plans and finding pragmatic solutions to immediate issues and problems at hand.

- **Improving policy coordination in the government** would be important for trade and tourism. In both these areas there are a large number of agencies with overlapping mandates. Improvement in Trade logistics, for example, needs coordination between the Treasury, Transport, and Trade Ministries.

- **Deepening civil service capacity** would improve implementation. This does not necessarily mean higher wages for top civil servants. Instead, it could mean developing a cadre of qualified senior civil servants with well-defined career succession plans.

- **Establishing strong feedback mechanisms to improve implementation and fine-tune policy**. Feedback mechanisms are not only about collecting good quality information, but also about making changes to policy in response. They also include evaluation of government programs and two-way open communication with the private sector.
Above all, the growth strategy should be part of politically shared development strategy. The Vision 2030 process has created a political convergence of sorts on the development strategy. It remains to be seen how robust it is to alternative leadership. Continuing efforts to strengthen political stability (including avoidance of scandals) is critical.
1. INTRODUCTION

1.1 The Kenyan economy has come a long way since 2002. Political uncertainty loomed before the December 2002 elections. It was not clear if elections would loosen the grip of the incumbent president, whose 24 years in power were rife with corruption and had severely hampered the economy. The political uncertainty came with attendant uncertainty about economic outlook. Investor confidence was low and the government's relations with donors were at an impasse. Interest rates were high, as the government borrowed heavily from the domestic market to shore up fiscal resources. In short, the economy was moribund. The peaceful change in political leadership produced a large economic dividend. Starting in 2003/4, there was a perceptible change for the better in Kenya's economic outcomes. Interest rates declined, external assistance started flowing in, investor confidence jumped, and growth prospects improved (see Appendix A).

1.2 The NARC government built upon the opportunity provided by the peaceful political transition. It strengthened the inherited foundations for growth during its five years in office. It strengthened macroeconomic stability through continued fiscal discipline. It built upon the good feeling created by the peaceful political transition of 2002, and promoted an environment where businesses were not overly concerned about politics. As a result, the economy continued to hum along well in a pre-election year, something unthinkable five years ago. It also deepened structural reforms: regulatory reforms were initiated; parastatal reforms were carried out in the telecommunications, railway, and energy sectors; and trade openness improved with the formation of Eastern Africa Community (EAC). Growth surged as the economy recovered from a decade-old period of stagnation.

1.3 However, the NARC administration did not go far enough. It did not make a serious dent on the problem of corruption, crime, and insecurity, which are all equally important elements of the business-government relationship. In addition, the widespread perception that political risk had fallen turned out to be premature and deeper determinants of political instability in Kenya came to the top. Structural reforms in the financial sector have made limited progress; specifically the issue of low efficiency in government-influenced banks remains unaddressed. Much needed reforms at Mombasa port have not progressed far enough, either.

1.4 The postelection crisis demonstrated the fragility of Kenya's political stability. It raised questions about the strength of institutions in ensuring peaceful political transition. The crisis also demonstrated the importance of political stability to economic development in Kenya. There was almost a unanimous view during the crisis that Kenya's growth spell would come to an abrupt end in the absence of political certainty.

1.5 The challenge before the new government is to take the economy to the next phase of development. The central message of this report is that despite the recovery, the economy is not yet at a stage of development where higher or even current growth rates—around 6 percent per year—can be safely assumed. Serious bottlenecks to investment, and thus to growth, continue. Infrastructure services remain costly and unreliable. Institutions at a micro level, such as those dealing with trading across borders and providing security, are not efficient and do not deliver effectively. The government has not managed to make a major dent in the problem of corruption. Above all, despite being better developed relative to regional neighbors, the economy is
underdeveloped relative to faster growing economies in the world with which Kenya should compare itself.

1.6 Poverty has declined since 1997, but the number of poor remains large and poverty remains widespread. The percentage of individuals living below the poverty line declined slightly between 1997 and 2005/6, from 52.6 percent to 46.6 percent, the Kenya National Bureau of Statistics (KNBS) reports (Government of Kenya, GoK, 2007a). However, there are significant geographical differences in the incidence of poverty. The proportion of the population below the absolute poverty line is the lowest in Central province, followed by Rift Valley, Nyanza, Eastern, Western, Coast, and North Eastern provinces, according to the KNBS report.

1.7 Creating enough jobs for a burgeoning labor force remains a major challenge for the government. A report on labor matters being prepared by the World Bank (World Bank 2007c) estimates that the Kenyan labor force is growing at an annual rate of about 2 percent. With this rate of growth, an estimated 350,000 to 400,000 new entrants seek jobs every year. Inability to create good jobs at a pace faster than the growth of labor force has resulted in open unemployment, estimated at 1.4 million—about 10.5 percent of the labor force (Pollin, Githinji, and Heintz 2007). The problem is more acute in urban areas due to accelerating urbanization.

1.8 Against this background, the Kenyan leadership has rightly identified strong broad-based growth as the main economic goal of Vision 2030. Experience elsewhere shows that growth is the basic key to reducing poverty and creating jobs. This has been Kenya's experience as well. During the 1990s, lack of growth coincided with increase in poverty and decline in human development indicators. However, these trends were arrested, or even reversed in some cases, with the ignition of growth after 2002.

The Objective and Scope of this Report

1.9 The main objective of this report is to help inform the government's medium-term plans for implementing Vision 2030. The report attempts to do this in two ways. First, it applies the insights from the recent empirical work and experience in other high growth countries to Kenya to propose a growth strategy. The strategy, so developed, would validate and likely help sharpen the broad thrust and direction of the ongoing reform efforts. Second, it drills down selectively into certain aspects of the growth strategy to generate a set of specific policy and institutional reforms. The net result is a reform agenda consisting of detailed policy actions that are expected to add up to a well-articulated growth strategy.

1.10 Apart from influencing government action, the report is also expected to influence thinking about growth in policy circles outside the government. In its analysis, the report draws upon the state-of-the-art thinking on the issues of growth, which is going through considerable rethinking among economists and practitioners. Among several departures from the conventional view, the new thinking shies away from providing prepackaged answers to an economy's problems and emphasizes country-specific analysis instead. Similarly, the focus has shifted from

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2 The estimate of the incidence of poverty for 2005/6 is not directly comparable to the earlier one because of differences in methodology, so these results need to be treated with caution.

3 World Bank (2007c) uses labor force data from 1998. It is possible that the rate of growth of labor force has slowed down since then. Pollin, Githinji, and Heintz (2007) estimate a labor force of 13.5 million in 2005/06, which would be consistent with a growth rate slower than 2 percent. These estimates would be reconciled once KIHBS micro-data become available to a wider pool of researchers.
identifying correlates of growth at a macroeconomic level (as in growth regressions), to identifying constraints to growth at a microeconomic level. This report reflects this shift in thinking and draws mainly upon analysis specific to Kenya (such as growth diagnostics and Investment Climate Assessment, ICA) to arrive at conclusions relevant to policy choices. We would hope that the approach and methodologies of this report influence future thinking about growth issues in Kenya.

1.1 The report is deliberately selective in scope and coverage, rather than comprehensive. It lays a particular emphasis on the economic pillar of the Vision 2030 and more specifically on how to overcome the constraints to accelerating growth in the medium term. There are two types of omissions. It leaves out several areas, which would be important components of an overall development strategy. Moreover, some areas that are identified as important components of the growth strategy are not developed fully in the report. Examples of both types of omissions are described below. Various passages in the report also identify areas that would need further analytical work.

1.12 Most importantly, the report leaves out discussion about distributional consequences of growth and their implications for the growth strategy. This discussion would be relevant for the social pillar of Vision 2030. It is well accepted that growth helps everyone, including the poor. At the same time, benefits of growth can be unevenly distributed; for example, across different regions of the country, between labor and owners of capital, between men and women, and between low-skilled and high-skilled workers. Given the high levels of poverty and inequality, patterns of growth are material to a discussion of growth strategy in Kenya.

1.13 As an example of the importance of patterns and sources of growth to poverty, research shows that in Kenya, growth in the agriculture sector would have a much bigger impact on poverty than that in other sectors because more poor are located in rural areas and are engaged in agricultural activities (Kiringai, Thurlow, and Wanjala 2006). Therefore, a strategy for improving agricultural productivity should be seen as an integral part of the development strategy that gives attention to poverty and employment. The Bank is engaged in ongoing work on agriculture sector policies for enhancing productivity growth. That work should be read as a complement to the growth strategy described in this report. Appendix B has a brief excerpt of preliminary recommendations coming out of that work.

1.14 In Kenya, informal employment is large and has been a concern for policymakers for a long time. Many aspects of the growth strategy proposed in this report such as improving access to finance for rural and small entrepreneurs and reducing regulatory hurdles would be important components of a development strategy that gives attention to informal employment. However, this report does not go into a deeper discussion of what additional incentives could be created for informal businesses to formalize. Given recent data collection efforts, it should be possible to carry out more policy work on informal sector in the future.

1.15 A related area is the issue of relatively high inequality of income, which even has implications for sustainability of growth. The spatial dimension of income inequality and the role of public action, especially public goods, in addressing inequality is an area for further analysis, which is partly being covered by the ongoing joint work on the poverty assessment by the Government of Kenya (GoK) and the World Bank.

4 The other two pillars are the social pillar and the political pillar.

5 On the other hand, growth in the industrial and services sectors has a bigger impact on reducing urban unemployment, which is an important social and political goal in itself.
1.16 Some aspects of the growth strategy proposed by this report, which are not covered in detail in this report, but are material to discussion of such strategy in Kenya, are the following:

- **Policy issues in the energy sector.** The report identifies the high cost and poor reliability of electricity services (frequent outages) as one of the major complaints of private sector. The key issues relate to regulatory efficiency: in particular, ensuring the separation of the Energy Regulatory Commission from political considerations, pricing of electricity to maintain the financial viability of power companies, developing incentives for power sector operator to improve operational efficiency, and developing a plan for energy security over the longer term (for example, by facilitating regional energy trade). Another set of issues are ensuring the use of appropriate least-cost criteria to select rural electrification schemes, and defining clearly stated criteria for allocating capital subsidies for rural electrification projects balancing economic, financial, and equity considerations.6

- **Access to finance.** Based on ICA 2007 and another survey of financial access (see paragraph 3.15), this report identifies access to financial services, particularly credit services, to be a constraint on investment by small businesses and rural investors. However, specific policy recommendations are not developed, pending further work.

- **Reducing corruption and improving security.** These are the subjects of ongoing analytical work by donors, and policy actions at several levels in the government. Therefore, this report does not include discussion on governance issues, even though they are identified as important for accelerating growth.

How this Report Relates to Vision 2030

1.17 This report reinforces the findings of the Vision 2030 document in several areas, adds value in many others, and modifies some. Like Vision 2030, this report identifies "securing political stability, achieving balanced fiscal and monetary policy, improving business climate, attracting investments and improving trade, and stimulating productivity" as important economic pre-conditions for sustained growth. Further, this report agrees with the Vision that tourism, manufacturing, and service sectors based on information and communication technology (ICT) are likely engines for growth. The main value-added by this report, however, is in providing a consistent macroeconomic framework for thinking about growth process and in throwing light on relative roles of accumulation and productivity in growth process. In addition, it draws upon rigorous Kenya-specific microeconomic analysis to unbundle productivity, and provides a detailed set of policy actions to improve productivity across the whole economy, including in specific growth-engine sectors. Such analysis, in many places, modifies the findings of the Vision. For example, on business climate, this report’s analysis and recommendations draw upon the latest investment climate survey. This survey shows that Kenya’s labor costs do not hurt competitiveness: a finding at odds with the emphasis on labor cost reduction in the Vision.

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6 These issues are being addressed in various ways. In 2007, a major study of tariffs in power sector was completed by Fitchner (a German consulting firm). In addition, Kenya Power and Lighting Company’s (KPLC) performance contract with the government contains 25 performance targets; seven of these performance targets are explicitly included in KPLC’s management contract with Manitoba Hydro. The World Bank has recently prepared a study with The Earth Institute at Columbia University on costing of rural electrification projects.
1.18 There are many differences in emphasis and details as well. For example, the Vision lays significant emphasis on raising government investment—by as much as (cumulative) $3.5 billion during the first five years of implementation—for financing new investment projects. While this report advocates making cautious use of available headroom for domestic borrowing to finance capital projects, it lays more stress on rehabilitation of existing infrastructure (such as roads) and cautions against expansion of infrastructure without careful economic analysis. The report advocates a position that new investments targeted on specific sectors should be left to the private sector, with the government sharing the risk in a calculated manner through Public Private Partnership (PPP) transactions and helping develop financial markets further.

1.19 The report is much less emphatic than the Vision about the sectors (identified winners and flagship projects) on which government should focus for delivering the aspired growth. The emphasis of the report is instead on reducing business costs and improving productivity. These could be complemented with targeted policy actions to address sector-specific issues—such as government/market failures—and provide solutions, in close dialogue with industry groups and associations. This shift in emphasis has large implications for policy. It frees up the resources of the state—the capacity of policymakers and financial resources—to focus on generic reforms rather than implement and follow-up elaborate grand sector strategies.
2. GROWTH—DIAGNOSTICS AND STRATEGY

2.1 After prolonged stagnation, the Kenyan economy finally started to grow after 2002 (Figure 2-1). Remarkably, in 2006, real GDP grew at a rate of 6.1 percent followed by 7 percent in 2007. During the five years 2003-07, the average growth rate was 5.4 percent per year. Spurred by the economic successes of the last five years, the government has set out in its Vision 2030 document, an ambitious target of 10 percent annual real growth for 20 years from 2011 onward in order to catch up with the East Asian economies and become a middle-income country by 2030.7

Figure 2-1: Annual percent change in total GDP (market prices), 2002–07

![Figure 2-1: Annual percent change in total GDP (market prices), 2002–07](image)

Source: Economic Survey 2008, KNBS.

2.2 During 2003 to 2007, value addition expanded in all sectors of the economy, but services sector led. Hotels and restaurant, transport and telecommunications, and trading activities together expanded at an annualized 9 percent per year (Figure 2-2). The expansion of hotel, restaurant, and transport activities largely reflected increased volume of tourist arrivals. During this period, visitor arrivals increased by about 60 percent due to better marketing, improved perceptions about security, and increased volume of conference tourism. Transit transportation activities to neighboring countries (Uganda, southern Sudan, and Rwanda) also increased moderately. The demand for mobile telephony and other telecommunication products soared. Given the large size of the services sector (about 53 percent of the total economy in 2007), its growth contributed more than half the total growth in the economy from 2003 to 2007 (Table A-1, Appendix A). Agricultural output (about 24 percent of the total economy in 2007) also grew in an impressive manner, led by maize, coffee, and livestock products. The growth in manufacturing sector was less inspiring and resulted largely from increased supply of agricultural inputs for agro-based activities, an increase in clothing production, and cement output.

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7 The onset of growth is particularly welcome, since it followed zero or negative per capita income growth in eleven out of thirteen years from 1991 to 2003 (Figure A-1; Appendix A). Kenya would need to grow at 7.3 percent a year for 30 years to reach the current per capita income level of Malaysia. However, encouraging as it may be, the growth rate after 2002 cannot yet be termed "acceleration" as commonly defined in recent growth literature. Hausmann, Pritchett, and Rodrik (2004) define acceleration as the seven-year period during which real per capita GDP grows at rates over 3.5 per cent per year.
2.3 In terms of expenditure (demand) components, growth during the period 2003 to 2007 was led by gross fixed capital formation, which expanded at an average rate of 17 percent per year between 2003 and 2007. Within the capital expenditure component, transport equipment, and machinery and equipment were the main contributors, registering fast annual growth rates of 25 percent and 27 percent, respectively. The strong growth in expenditure on machinery and equipment is a good sign that businesses were investing in expanding production capacity in response to demand. However, there are indications that the expansion in capacity was more to meet regional demand, which has been expanding. In addition, growth in expenditure on transport equipment was partly for consumption, fueled by easier availability of consumer credit. Average growth of exports was 7 percent during this period (Table 2-1): clearly not spectacular. The fastest growing component of exports was tourism receipts. While the change in structure of exports has been encouraging, exports will need to play a more important role if growth is to be accelerated and sustained (see discussion below).

Table 2-1: Annual Percentage Change in Expenditure on GDP (constant 2001 prices)

<table>
<thead>
<tr>
<th>Expenditure category</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government consumption</td>
<td>6</td>
<td>0.6</td>
<td>-0.6</td>
<td>1.5</td>
<td>7.2</td>
</tr>
<tr>
<td>Private Consumption</td>
<td>2.2</td>
<td>2.4</td>
<td>6.4</td>
<td>7.6</td>
<td>7.3</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>-8</td>
<td>7.3</td>
<td>27.9</td>
<td>18.3</td>
<td>13.3</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>7.2</td>
<td>12.8</td>
<td>9.7</td>
<td>3.4</td>
<td>6.0</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>-0.1</td>
<td>12.3</td>
<td>15.0</td>
<td>18.2</td>
<td>12.7</td>
</tr>
</tbody>
</table>

Source: Economic Survey 2008, KNBS.
* Provisional.

2.4 When the whole economy is looked upon as one production unit, a large part of the increase in output from 2003 to 2007 remains unexplained after accounting for increases in physical capital and human capital (educational attainment of the labor force). Table 2-2 includes a decomposition of per capita economic growth from 2003 to 2007 into growth in stocks of physical and human capital and the residual component, Total Factor Productivity (TFP).<sup>5</sup>

<sup>5</sup> The Bosworth and Collins (2003) methodology is used for growth accounting. Human capital is approximated by an index that considers the returns to education and years of schooling of Kenyan
Physical capital accumulation contributed about one-half of the total growth per unit of labor during this period, while TFP growth "explains" the remaining one-half.

Table 2-2: Sources of Economic Growth, Selected Period Averages, 1960–2006

<table>
<thead>
<tr>
<th>Period</th>
<th>Average annual change in GDP per unit of labor (%)</th>
<th>Contribution to GDP per unit of labor change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Physical capital</td>
</tr>
<tr>
<td>1960-1980</td>
<td>3.0</td>
<td>0.4</td>
</tr>
<tr>
<td>1981-1990</td>
<td>0.7</td>
<td>-2.0</td>
</tr>
<tr>
<td>1991-2000</td>
<td>-1.2</td>
<td>-1.1</td>
</tr>
<tr>
<td>2001-2007</td>
<td>1.6</td>
<td>0.9</td>
</tr>
<tr>
<td>2003-2007</td>
<td>2.4</td>
<td>1.0</td>
</tr>
<tr>
<td>1960-2007</td>
<td>1.4</td>
<td>-0.4</td>
</tr>
</tbody>
</table>

Source: Staff calculations. GDP, investment, and labor force data are from World Development Indicators (WDI) database, World Bank. Capital stock data are from Nehru and Dhareshwar (1995). Factor shares in GDP are based on Economic Surveys, KNBS.

2.5 As measured above, TFP growth from 2003 to 2007 captures an improvement in the economy's productivity, as well as increased utilization of existing capacity. There is firm-level evidence for both these components. Data from the recent Investment Climate Assessment (World Bank 2007h ICA 2007 hereafter) shows that between 2002 and 2006, firm-level TFP improved by about 15 percentage points in manufacturing and capacity utilization improved by another 23 percentage points. Moreover, businesses, on average, showed an increase in employment without a commensurate increase in physical capital. The last finding is an indication that businesses were hiring more labor to make use of the existing capacity before adding fresh capital to expand capacity. (This was quite evident, for example, in the hotel industry.)

2.6 While there is evidence of TFP improvement at the level of firms, there is no clear evidence of TFP improvement resulting from reallocation of labor and capital across sectors, from less productive uses in the economy to uses that are more productive.

2.7 The main question is to what extent is the recently achieved growth rate sustainable over a longer term. Clearly, several factors came together to enable expansion of economic activity during 2003-7. Tourist arrivals, regional demand for Kenya's manufactures and transportation services, consumption demand fueled by remittances, and domestic demand for telecommunications services—all expanded. A favorable business climate enabled businesses to respond to increased demand by improving capacity utilization, expanding capacity, and population. For this purpose, estimates of returns to education by level are borrowed from Appleton, Bigsten, and Manda (1999) for 1978 and 1986, and from Manda, Mwabu, and Kimenyi (2004) for 1994. Barro and Lee (2000) estimates on average years of schooling (primary, secondary and higher education) for 1960 to 1999 are used. Returns on education and schooling years data are extrapolated as needed. The human capital index is multiplicative on the returns to education by level raised to the average years of education by year.

9 While it would be of interest to know the relative magnitudes of the two components, it is not feasible to disentangle the two at a macroeconomic level for a short period of five years.

10 ICA (2007) reports significant improvement in labor productivity and use of capital inputs, as well.
improving productivity. Clearly, both temporary and more permanent elements have contributed to Kenya's growth recovery. To assess the sustainability of growth over a longer term, the discussion now turns to factors that initiated recovery in the first place and have fueled it in the past five years.

**Foundations of Growth Recovery**

2.8 The onset of growth in 2003 coincided with a perceptible change for the better in other macroeconomic outcomes. Specifically, the analysis shows that the positive trends are being driven by three main factors. The first factor is the lagged effects of price, trade, exchange rate, and interest rate liberalization. The second is macroeconomic stability based on reduced indebtedness, and efficient and significant domestic revenue mobilization following sustained reform in tax policy and administration. Third are perceptions about improved political stability after the successful 2002 elections. Importantly, the first two factors were largely stimulated by reduced donor aid and Kenyan attempts to restore credibility after the Goldenberg scandal. The last factor had a role to play in lowering real interest rates.

<table>
<thead>
<tr>
<th>Box 2-1: Kenya's Economic Liberalization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic liberalization in Kenya was launched in January 1986, when the government decided to shift from <em>dirigisme</em> to freeing up the economy, as explained in Sessional Paper Number 1 (GOK 1986). After the Berlin Wall collapsed in November 1989, a series of incidents intervened and Kenya began to lose its geopolitical bargaining power (as it was the most prominent market economy in East Africa and the U.S. fleet was able to use the Mombasa port). Among these events were the following:</td>
</tr>
<tr>
<td>• November 1991: Emphasis in Consultative Group shifted abruptly from economics to governance. Donors froze aid.</td>
</tr>
<tr>
<td>• 1992: Kenya started building up external debt arrears; foreign exchange becomes the critical constraint.</td>
</tr>
<tr>
<td>• End 1994: IMF shadow program enabled Paris Club rescheduling.</td>
</tr>
<tr>
<td>In the interim, the Goldenberg scandal hit (1991–3), interest rates on Treasury bills soared to 80 percent because of a loss of monetary control, and banks allied to Goldenberg's Exchange Bank collapsed. Liberalization continued; by the end of 1994, prices, interest rates and the exchange rate had been liberalized. In the meanwhile, flows of aid became small and unpredictable. Since 1995, net foreign transfers to the government have been negative except for 2001, when a debt rescheduling occurred. As a result, domestic borrowing served not only to finance the deficit but also to pay down external debt.</td>
</tr>
<tr>
<td>Private sector firms interviewed in July 2006 invariably pointed to the liberalization, which picked up steam in 1993–94, as a critical, positive turning point for Kenya's economy.</td>
</tr>
<tr>
<td>Source: Various meetings with academicians, private sector firms, IMF files.</td>
</tr>
</tbody>
</table>

2.9 Box 2-1 briefly describes the main events related to economic liberalization. There is anecdotal evidence that economic liberalization decreased protection and increased competition and that the resulting compression of profit margins forced firms to become more efficient. For example, about two-thirds of the manufacturing firms surveyed in ICA 2007 report that in the past three years they have introduced a 'new or significantly improved process of production'—a higher rate of innovation than the average for countries in SSA. Manda (2004) records the churning in the labor market in the 1990s, following the liberalization. In addition, cutting of
import tariffs also helped improve the external orientation of firms by lowering the cost of imported machinery and raw materials (and reducing the tax on exports, by Lerner symmetry).11 External orientation of firms further improved after the East African Community (EAC) Customs Union came into being in 2005. For example, the simple average tariff fell from 16.8 percent in 2004 to 12.9 percent after the introduction of the EAC Common External Tariff (CET).

**Improved Business Environment—Macroeconomic Stability Due to Reduced Indebtedness**

2.10 Expansion in private investment was enabled by improved business environment. Two aspects of improved business environment were fundamental: one, macroeconomic policy credibility; and two, perception of the private sector that business decisions could be made without caring for politics. These two aspects together could be seen as behind the decline in country risk, which was an important factor behind the significant decline in real interest rates. At the microeconomic level, investment horizons lengthened because of improved certainty about government policies, which in turn, would result in lower hurdle rates of return for investment projects. The overall impact was a perceptible change for the better in Kenya’s macroeconomic outcomes.

2.11 Kenya’s current macroeconomic policy credibility rests on more than a decade of reform efforts Box 2-2. It rests largely on the successful fiscal consolidation after Goldenberg scandal and a significant decline in government indebtedness since 1995/96. In addition, Kenya has been able to lay a solid foundation for solvency of public finances based on efficient and significant own-revenue mobilization at about 21 percent of GDP. Indeed, Kenya’s ability to issue nominal (i.e., un-indexed) debt at single-digit interest rates is impressive. This indicates a high degree of macro policy credibility and the absence of “debt intolerance.”

**Box 2-2: Macro Stability and Solvency of Public Finances**

Macroeconomic stability does not depend upon today’s fiscal deficit and inflation alone. It needs to be seen in terms of a longer-term solvency of public finances—for which future growth and tax collection are equally important. Recent empirical work shows that a longer-term perspective on macroeconomic stability has two components. The first is a comprehensive approach to managing public finances. That is, apart from today’s fiscal deficit, bailouts, and contingent liabilities, the efficiency and predictability of taxation, the composition of expenditures, and the rate of return on public investments are equally important. The second component is sound macro-micro linkages. Firms and banks must have incentives to operate efficiently, thereby creating strong micro-foundations for future growth and taxes: essential underpinnings for a solvent government. Firms and banks, in turn, require macro stability, efficient taxation, reasonable real interest rates, competitive real exchange rates, and good infrastructure. These are directly influenced by macro management and decisions on the composition of public expenditures.

2.12 Figure 2-3 shows the path of Kenya’s debt-to-GDP ratio, as well as its currency composition over the period 1995/6 to 2006/7. The government debt-to-GDP ratio has fallen by some 27-percentage points over this period to a level of 46 percent by 2006/7, while the share of foreign-currency denominated debt has decreased from about 80 percent of total debt in 1996/7 to 60 percent in 2006/7.

11 Lerner Symmetry is a result in trade theory that states that if trade is balanced, an ad valorem tariff on imports has the same impact on relative prices as a tax on exports.
Table 2-3 provides more insight into the factors explaining the declining indebtedness by apportioning the change in indebtedness to the primary fiscal balance, growth, real interest and exchange rates, and other factors. In order to capture the recent improvement in macroeconomic conditions, divides the past decade into two sub-periods: 1996/97–2002/03 and 2003/04–2006/07. For each sub-period, the average annual change in the debt-to-GDP ratio is given, as well as the portion attributable to the factors mentioned above. The biggest factor explaining the sharp decline in the debt-GDP ratio is the joint effect of the GDP growth and the real appreciation of the Kenyan shilling after 2003. The decline in real interest rates also helped. The contribution of real interest rate to the rise in GDP-debt ratio was greatly reduced after 2003.\(^\text{12}\)

\(^{12}\) This report does not go into a detailed analysis of reasons for the decline in interest rates after 2002. A likely reason for the decline appears to be the fall in country risk premium, discussed in Appendix D along with other plausible reasons.
<table>
<thead>
<tr>
<th></th>
<th>1996/7–2002/3</th>
<th>2003/4–2006/7</th>
<th>1996/7–2006/7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in public sector debt</td>
<td>-1.8</td>
<td>-4.9</td>
<td>-2.7</td>
</tr>
<tr>
<td>Contribution from:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Primary deficit (- surplus)</td>
<td>-2.5</td>
<td>-0.1</td>
<td>-2.2</td>
</tr>
<tr>
<td>2. Real GDP growth</td>
<td>-1.4</td>
<td>-2.6</td>
<td>-1.8</td>
</tr>
<tr>
<td>3. Real interest rate</td>
<td>2.1</td>
<td>0.5</td>
<td>1.6</td>
</tr>
<tr>
<td>4. Real exchange rate (- appreciation)</td>
<td>0.6</td>
<td>-2.4</td>
<td>0.0</td>
</tr>
<tr>
<td>5. Other factors</td>
<td>-0.6</td>
<td>0.8</td>
<td>-0.2</td>
</tr>
</tbody>
</table>

*Source:* Staff calculations, based on data from Kenyan authorities, IMF Staff Reports, and World Bank.

2.14 Notably, the decline in indebtedness and interest payments occurred even though the primary fiscal surplus (including grants) declined as a share of GDP (Figure 2-4). Two main arguments to explain this feature are that the rather high level of primary fiscal surplus after the Goldenberg scandal was a part of an attempt to bolster credibility and carry out fiscal consolidation; there was a slow return to more natural levels in the later half of the 1990s. The second argument is that interest rates in the first half of the 1990s were being driven by factors other than fiscal fundamentals. Box 2-3 discusses the latter argument in some detail.
Box 2-3: Shrinking Primary Fiscal Surpluses and Declining Interest Payments

Figure 2-4 plots the primary balance and interest payments, both as a percentage of GDP, from 1990 to 2006. Two observations stand out. First, the primary fiscal surplus (with grants and after cash adjustment) went up in the wake of the Goldenberg scandal and reached close to 6 percent of GDP by the mid-1990s, but has been on a declining trend ever since. Second, interest payments peaked at over 10 percent of GDP in 1993/4 but have then fallen from 6 percent of GDP in 1995/6 to 2.4 percent in 2006/7, even as the primary fiscal balance was deteriorating.

There are two possible explanations for this apparent paradox. First, the Goldenberg scandal prompted a large increase in the primary fiscal surplus in an attempt to bolster credibility. Second, interest rates were being driven by factors other than the fiscal fundamentals. Once these factors attenuated, interest rates and interest payments came down. The first explanation is validated by the figure, and the second explanation has some credence. Between 1991 and 1993, Kenya suffered from the Goldenberg scandal, which is estimated to have had a cumulative cost of $600 million to $1 billion: some 9 to 16 percent of 1994 GDP. The scandal was uncovered in 1992 and the efforts to mop up excessive monetary infusion arising from the scandal pushed interest rates on T-bills to over 80 percent. The breaking of the scandal only intensified the pullback of the donors, forcing Kenya to rely on domestic debt, which was “more expensive.” This was also the time that Kenya started shifting to domestic debt to pay off maturing external debt because of the aid squeeze.

2.15 Kenya’s current debt situation has several strengths. Most important is Kenya’s ability to issue nominal (that is, unindexed) debt at single-digit interest rates. Even countries such as Brazil and Turkey have not been able to do so in spite of running significant primary surpluses (far greater than Kenya’s) for several years in a row (Brazil, since 1999). This indicates a high degree of macro policy credibility in Kenya and the absence of “debt intolerance,” developed over more than a decade. Further, Kenya’s debt structure is less vulnerable to external shocks because of the falling share of external debt over the past decade. Finally, Kenya’s debt dynamics are favorable...
and it has been growing impressively over the past five years, in contrast to the debt sustainability
problems and slow growth in many other countries.\(^{13}\)

**Improved Business Environment—Decline in Political Interference and the Government’s
Business-friendly Attitude**

2.16 Interviews with private sector and participants in financial markets show that they
perceived the peaceful political change in 2002 as a watershed event. The change of political
leadership was seen as a successful transition to multiparty democracy, a process that began in
1992. Economic agents widely believe that Kenya’s political development is irreversible and
economic policies are unlikely to change dramatically with changes in political leadership.\(^{14}\)
These developments can be construed as improvements in political and economic risk by the
investors.

2.17 The reduction in political risk that accompanied the change in political leadership in
2002 fueled an improvement in sovereign creditworthiness and the private investment climate,
thus permitting Kenya to begin reaping the benefits of political and economic reforms that date
back to at least 1986. Improved sovereign creditworthiness has resulted in a reduction in country
risk that showed up in a fall of real interest rates and greater willingness of firms to invest without
concerns about political interference.\(^{15}\)

2.18 The findings of ICA 2007 confirm that at a microeconomic level, perceptions about
political stability, together with macroeconomic stability, improved significantly between 2003
and 2007. In the 2007 assessment, about 16 percent of respondent manufacturing firms perceived
political instability or uncertainty as a major to severe constraint to business, compared to a
significantly larger 52 percent in 2003. Similarly, the percentage of manufacturing firms that
consider macroeconomic stability to be a major constraint to business dropped to 26 percent in
2007 from 51 percent in 2003.\(^{16}\) A reduced perception of risk is apparently leading to lengthening
of business horizons and thus a lower hurdle rate of return.\(^{17}\) About 59 percent of the firms

\(^{13}\) The debt dynamics do not take into account significant unreported contingent liabilities from a large
parastatal sector and unfunded future pension obligations. A fiscal Report on the Observance of Standards
and Codes (ROSC) carried out by the IMF in 2007 estimated these two sets of liabilities at a cumulative 20
percent of GDP. Due to non-accounting of contingent liabilities, Kenya’s domestic debt is likely to be
underestimated.

\(^{14}\) A statement by Titus Naikuni, chief executive of Kenya Airways, reported in the June 13, 2007
Financial
Times, characterized the attitude of businesses at that time. He said, “I think we’ve sort of separated the
politicians, who are making noise, from those of us who want to make money. Because the politicians
realize that without this money we won’t have development.” Of the election, he said, “It’s time people
realized Kenya has become very mature, in the sense that the business community couldn’t care less about
what happens. I don’t put our business plans based on whether we’re going to elect Kibaki or someone
else.”

\(^{15}\) The decline in real interest rate has also been accompanied by a sharp reduction in the average interest
rate spread charged by banks, reducing the cost of borrowing for the private sector. This reduction reflects
greater competition, which has led banks to focus more intensively on providing finance to previously
under-served or un-served markets. See Appendix C for an analysis of spreads.

\(^{16}\) These findings are based on a panel of 160 firms that participated in both surveys.

\(^{17}\) A firm seeking to recoup an investment over three years rather than six years is likely to require a much
higher rate of return because the rate of capital depreciation would be much higher. One would also expect
to see a greater willingness to hold assets denominated in Kenyan shillings in the banking system.

Weaknesses of the Current Growth Spell

2.19 With the resumption of normalcy in political and social life, economic expansion is expected to resume, but high growth, even at pre-crisis levels, cannot be assumed. There are two reasons. First, the two underlying causes behind the recent growth, discussed above have weakened. Macroeconomic policy credibility is likely to be under strain in view of the fiscal pressures of crisis-related expenditure and demands of a coalition government and double-digit inflation during 2007. In addition, estimates of political risk are likely to have been revised following the political crisis. The expectation is that political uncertainty will linger on, thereby keeping away significant new investment, particularly by foreigners in the near term. Second, the five-year growth spurt had temporary components—both domestic and external in origin—that cannot be assumed in the future. The domestic component was the improvement in capacity utilization after prolonged stagnation, and the external component was the favorable environment such as low international interest rates and high growth rates in partner countries. The latter particularly lies beyond the influence of Kenyan policy makers. Excluding the cyclical expansion, trend growth rate during the past five years was low, as was the annual rate of fixed capital formation (the latter around 15 percent of GDP). To ensure that the Kenyan economy is on a steeper trend growth rate, much more would need to be done as discussed below.

2.20 The main question faced by policymakers is that if political and macroeconomic stability are maintained, what more would be needed to accelerate and sustain growth over long run in Kenya. The answer to this question lies in understanding the constraints to accelerating and sustaining growth. Empirical work shows that constraints to accelerating growth at a particular time (proximate constraints) may differ from constraints to long-term sustained growth (deeper constraints). Therefore, this report carries out analysis towards understanding constraints to growth at three levels. First, a benchmarking exercise is carried out, comparing Kenya with successful economies, to highlight areas where Kenya would need to make deeper efforts to achieve sustained growth. Second, a growth diagnostics exercise is carried out to understand the nature of binding constraints to accelerating growth in the medium-term. This exercise asks the question as to why investment rate is low in Kenya. Finally, a macroeconomic perspective is developed to look at the feasibility of a very high growth rate—such as 10 percent envisioned in the Vision 2030. These analyses are then combined to propose a strategy for accelerating and sustaining growth.

Binding Constraints to Accelerating Growth in Kenya

2.21 Identifying and prioritizing the most significant (binding) bottlenecks will be important to realize gains from growth quickly. This study applies a growth diagnostics approach—along the lines of Hausmann, Rodrik, and Velasco (2005)—to identify binding constraints to accelerating growth in Kenya. The binding constraint approach posits that not all constraints matter equally
for growth at all times and growth acceleration need not wait for a resolution of all constraints. At a given point of time, addressing certain constraints will provide higher value (in terms of growth) than addressing others.

2.22 The diagnostics approach shows that the investment rate is low in Kenya for two broad reasons. First, returns to investment are low and risks to appropriation of returns by private investors are high. Second, access to finance is limited and costs are high for certain categories of borrowers, such as rural and small entrepreneurs. Returns to investment are low, in turn, mainly because non-factor costs—other than the cost of labor and capital—are high. These nonfactor costs take various forms. They include high logistics costs and high costs of energy. They also include opportunity costs due to delays of shipments, as well as direct payments in the form of bribes. The net impact of these nonfactor costs on a business is either reduced sales revenue—and hence reduced profitability and productivity (as measured)—or high total costs of production.

2.23 On the issue of risk to appropriation of returns, macroeconomic and political risks have receded considerably since the 2002 elections. However, risks due to corruption, crime, and the security situation remain deterrents to investment.

2.24 Certain constraints do not act as binding on investment, the diagnostics exercise finds. It finds that scarcity of human capital does not act as a binding constraint currently. Various enterprise surveys bear out this conclusion, since businesses do not identify skills supply as a major constraint to business. This finding should not be construed as saying that Kenya should not continue to invest in expanding the stock of human capital. All it does is to highlight that at present, investment—and hence growth—is not being held back by lack of general skills. This view would be consistent with a tight supply of specific skills in certain industries.

2.25 Likewise, while investment in innovation and research in Kenya is low, at Kenya’s current stage of development, these are not seen as likely binding constraints. Kenya is still seen as operating well inside the world technology frontier and innovation is more likely to take the form of copying and adapting than creating new products. However, it is possible that as the economy grows further, some of the constraints that are not binding now could tighten. For example, at some stage there may be a need to provide public support to innovation through investment in R&D.
2.26 Is the cost of financing investment a binding constraint to growth in Kenya? In other words, is investment low because either domestic or foreign savings become available to the private sector at high cost? On the face of it, cost of finance may not be acting as a binding constraint. Deposit rates and lending rates have been relatively low in Kenya, particularly after 2002. The average lending rate by commercial banks after 2002 was about 13.2 percent with very low volatility. The view that cost of finance may not be acting as a binding constraint is echoed by respondent manufacturing firms in ICA 2007; only 28 percent of them rated access to finance as a major or severe constraint to business. However, smaller and rural borrowers report much restricted access to financial services. Chapter 3 reports more on issues related to access to financial services.

2.27 Moreover, cost of finance could become a binding constraint in future. While Kenya's financial systems are well developed by regional standards, they lack the depth and efficiency to deliver high levels of growth. In 2006, the ratio of financial system deposits to GDP was 34.6 percent, while the ratio of bank deposits to GDP was 33.1 percent. Those figures compare favorably with other African countries, where average bank deposits/GDP hover near 25 percent, but they remain however substantially below the averages for higher growth regions like East Asia Pacific (51.4 percent) and South Asia (46.3 percent). Private credit to GDP—a key indicator for intermediation efficiency—shows a similar profile, at 24.3 percent in 2006 for Kenya, exceeding the Africa region average, but significantly below the averages for East Asia Pacific (43.0 percent) and South Asia (38.3 percent). Using estimates from cross-country regressions in Beck and Levine (2004), were Kenya's private credit/GDP ratio to increase from roughly 25 percent to 35 percent, its real per capita GDP growth would increase by 0.4 percentage points per year.

2.28 There are indications that banks in Kenya have become more efficient after 2002. Banking sector interest rate spreads—another indicator of intermediation efficiency—declined to a little more than 8 percent in 2006 from about 12 percent in 2002. Analysis carried out for this report shows that decline in spreads reflects improved competition among banks for lending opportunities. The increased competition resulted in banks cutting their costs; however, efficiency improved much more in private banks than the government-influenced banks. Overhead costs of government-influenced banks remain high. Appendix C has more information on banking sector efficiency in Kenya.

Kenya’s Prospects for Sustained Growth—A Look at Deep Determinants of Growth

2.29 Empirical evidence from various studies shows that growth accelerations and sustained long-term growth may have different drivers. In other words, constraints to accelerating growth at a particular time may differ from constraints to long-term sustained growth. The discussion that follows analyzes how Kenya's prospects for sustained growth are influenced by deeper determinants of growth: namely, geography, institutions, and global integration.

2.30 Geography is arguably the truly exogenous factor and an important determinant of growth. It in large part determines the opportunities for economic development. Recent work by Collier and O'Connell (2006) shows that a coastal country has an average advantage of 1.5

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22 Lending rates were particularly high in 1998 and 1999 (around 25–26 percent) when large domestic borrowing by the government resulted in high interest rates.


24 Background paper ‘Financial Sector Efficiency and Outreach in Kenya’.
percentage points in economic growth relative to a landlocked country.\(^{25}\) On average, being resource-poor is found to be an advantage since the benefits of the resource endowment do not outweigh the costs that frequently affect resource-rich countries associated with Dutch Disease or governance problems—and even conflict. Collier and O’Connell, however, caution that the probability of economic success for coastal, resource-poor countries in Sub-Saharan Africa depends upon government’s avoidance of predatory actions on the exportable sector (the regulatory syndrome). Their empirical findings support this argument and show that resource-poor African coastal economies, such as Mauritius, that have managed to avoid such actions have succeeded in new export markets. According to this viewpoint, being coastal and resource-poor, Kenya could have a growth advantage—in terms of opportunities—as similarly situated countries, but policy choices must be made in a way to exploit that potential. The good news is that with the structural reforms of the 1980s and the 1990s, and the political transition in 2002, the regulatory syndrome has attenuated in Kenya and export promotion is more clearly articulated as a key development objective. The bad news is that Kenya has far to go in making full use of its geographic advantage, as discussed later in this report.

2.31 However, geography is not everything. Other deep determinants of growth are institutions and the extent of a country’s integration into the global economy. Rodrik, Subramanian, and Trebbi (2002) find quality of institutions to be a more relevant variable for explaining income differences across countries.\(^{26}\) Their work suggests that, once institutions are controlled for, measures of geography and integration remain just slightly important for explaining income; however they remain as relevant, indirect, explanatory variables through their ability to influence the quality of institutions.

2.32 The analysis in this study draws upon the recent work done by Johnson, Ostry, and Subramanian (2007) to benchmark Kenya on selected indicators related to institutions and global integration that have been found in the literature to matter for sustained growth.\(^{27}\) Kenya is compared with two sets of countries. The first set consists of Sub-Saharan African (SSA) countries that are not resource-rich and not post-conflict, and that have grown at more than 2 percent per capita from 1996 to 2005 (called fast-growing SSA countries). The second set

\(^{25}\) Collier and O’Connell (2006) classify countries according to their growth opportunities and policy choices. Opportunities are given by two attributes of an economy: endowments and location. Choices refer to strategic policy approaches such as import substitution versus export promotion and the provision of public goods. The authors classify countries into four mutually exclusive groups by interacting endowments (resource rich/resource poor) with location (coastal/landlocked). Other authors also find geography to be important for growth: see Sachs and Warner (1997) and Gallup, Sachs, and Mellinger (1999).

\(^{26}\) Rodrik, Subramanian, and Trebbi (2002) measure quality of institutions using a composite indicator of a number of elements that capture the protection afforded to property rights as well as the strength of the rule of law. Rodrik (2008) expands the scope of desirable institutions, beyond protecting property rights and ensuring that contracts are enforced, to include those that stimulate entrepreneurship, foster integration in the world economy, maintain macroeconomic stability, manage risk-taking by financial intermediaries, supply social insurance and safety nets, and enhance voice and accountability.

\(^{27}\) The exercise in Johnson, Ostry, and Subramanian (2007) is strictly a benchmarking exercise. The authors do not carry out growth regressions. They instead draw upon literature to identify indicators (variables) that have been found to matter for sustained growth. As is always the case, the benchmarking exercise flags areas for attention and deeper analysis without assigning any explanatory significance to indicators used.
consists of 12 countries that have sustained high growth rates over a long period (called Sustained Growth countries), as defined by Johnson, Ostry, and Subramanian (2007).28

2.33 Table 2-4 displays Kenya’s scores on a number of indicators of quality of institutions, compared across countries. It shows that Kenya’s position on quality of political and broad economic institutions is mixed. Overall, Kenya’s (current) measures of quality of political and broad economic institutions appear to be on par with or better than comparable measures of fast-growing SSA economies or sustained growth comparators. Institutionalized constraint on executive decision-making, a measure of political institutions, is much higher for Kenya than for the fast-growing SSA economies or the sustained growth economies at the start of growth episode. However, the recent political crisis has highlighted the inherent weakness of institutions to ensure smooth political transition in a democratic context. Kenya’s scores on both economic risk and investment risk are also better than the sustained growth economies in mid-1980s and fast-growing SSA economies in 2006. Given that by the mid-1980s, the sustained growth economies had already been growing for more than a decade and their institutions had likely improved in a virtuous cycle of growth and institutional quality, Kenyan institutions look even better.

2.34 However, income inequality, which is likely to be associated with political and broad economic institutions, is higher in Kenya than it was in the sustained growth economies. This could be an obstacle to political stability. Research shows that in countries with higher initial income inequality, growth spells tend to be shorter (Berg, Ostry, and Zettlemeyer 2006). In other words, this evidence would suggest that Kenya’s growth spells would have a relatively higher risk of being derailed because of higher inequality. Therefore, mitigating income inequality should be seen as a part of long-run growth strategy.

Table 2-4: Indicators of Political and Broad Economic Institutions, Fast-Growing SSA Countries, Sustained Growth Countries, and Kenya

<table>
<thead>
<tr>
<th>Indicator (range)</th>
<th>Fast-growing SSA countries – average (year)</th>
<th>Sustained growth countries – average (year)</th>
<th>Kenya (year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher inequality</td>
<td>49</td>
<td>39.5 (7)</td>
<td>43</td>
</tr>
</tbody>
</table>

a. Polity IV database.
b. ICRG database.
c. Normalized Kaufmann-Kraay index.
d. WDI database.
e. See footnote 28 for the definition of year T.

In addition, if we use the wider definition of institutions as in Rodrik 2008 (see footnote 26), we find that micro-level institutions are problematic in Kenya. The results of ICA 2007 show that security situation is also much worse than most comparator countries. As measured in terms of costs of doing business, including costs of trading, Kenya does worse than both fast-growing SSA economies and sustained growth countries. On control of corruption, Kenya scores below both groups (Table 2-4).

Kenya is also significantly disadvantaged on measures of social fractionalization (ethnic, religious, and linguistic), compared to sustained growth comparators (Table 2-5). It is disadvantaged even compared to fast-growing SSA economies. Globally, there is evidence that social fractionalization affects economic outcomes and hurts growth due to ethno-regional biases in policy, particularly the provision of public goods. It also indicates a higher potential for conflict and derailing growth. Indeed, development of a credible political compact that could provide the glue to bring together ethno-regional fractions remains a social and economic challenge in Kenya, as in many other African countries.

Table 2-5: Indicators of Social Fractionalization, Fast-Growing SSA Countries, Sustained Growth Countries, and Kenya

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Fast-growing SSA countries average</th>
<th>Sustained growth countries average</th>
<th>Kenya</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ethnic</td>
<td>0.72</td>
<td>0.30</td>
<td>0.83</td>
</tr>
<tr>
<td>Ethnic</td>
<td>0.75</td>
<td>0.33</td>
<td>0.85</td>
</tr>
<tr>
<td>Religion</td>
<td>0.53</td>
<td>0.30</td>
<td>0.70</td>
</tr>
<tr>
<td>Ethnic</td>
<td>0.68</td>
<td>0.32</td>
<td>0.86</td>
</tr>
<tr>
<td>Linguistic</td>
<td>0.76</td>
<td>0.29</td>
<td>0.89</td>
</tr>
<tr>
<td>Religion</td>
<td>0.54</td>
<td>0.42</td>
<td>0.78</td>
</tr>
</tbody>
</table>

Note: A higher value represents higher fractionalization.

In terms of integration into global trading activities, at a first glance, Kenya does not look much different from the sustained growth countries at the start of their growth acceleration (Table 2-6). The current exports-to-GDP ratio is comparatively high, at about 25 percent. The share of manufacturing exports in total exports is also comparable to the levels in sustained growth countries at the start of the growth acceleration. This insight is meaningful because manufacturing exports were the prime engine for growth in almost all sustained growth countries. The share of low value exports such as apparel is also low. Therefore, in terms of structure of exports, Kenya does not look much different from sustained growth countries at the beginning of their growth episodes.

The findings of ICA 2007 are discussed in detail in Chapter 3.
Table 2-6: Macroeconomic and Trade - Policies and Outcomes, Fast-Growing SSA Countries, Sustained Growth Countries, and Kenya\(^a\)

<table>
<thead>
<tr>
<th>Measure</th>
<th>Fast-growing SSA countries average</th>
<th>Sustained growth countries - average</th>
<th>Kenya</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total exports to GDP</td>
<td>25.1</td>
<td>19.1(^c)</td>
<td>24.7</td>
</tr>
<tr>
<td>Manufacturing exports to GDP</td>
<td>4.8</td>
<td>2.2</td>
<td>3.2</td>
</tr>
<tr>
<td>Apparel, footwear, textiles exports to GDP</td>
<td>3.9</td>
<td>1.1</td>
<td>0.5</td>
</tr>
<tr>
<td>Fuel and ore exports to GDP</td>
<td>3.1</td>
<td>4.2</td>
<td>3.1</td>
</tr>
<tr>
<td>Agriculture and food exports to GDP</td>
<td>7.3</td>
<td>7.8</td>
<td>7.7</td>
</tr>
<tr>
<td>Trade restrictiveness (0–1)(^b)</td>
<td>0.9</td>
<td>0.4</td>
<td>1</td>
</tr>
<tr>
<td>Balassa-Samuelson average currency overvaluation</td>
<td>10.8</td>
<td>-17.7</td>
<td>9.4</td>
</tr>
<tr>
<td>Largest consecutive spell of overvaluation in years since 1970</td>
<td>15.4</td>
<td>6.4</td>
<td>21</td>
</tr>
<tr>
<td>Average overvaluation during largest spell</td>
<td>43.8</td>
<td>11.4</td>
<td>16.9</td>
</tr>
<tr>
<td>Inflation</td>
<td>7.3</td>
<td>14.6</td>
<td>10.3</td>
</tr>
<tr>
<td>Aid to GDP</td>
<td>13.3</td>
<td>4.7 ((T-4 \text{ to } T+5))</td>
<td>4</td>
</tr>
</tbody>
</table>


a. Average for years after 2000 unless otherwise indicated.

b. Sachs-Warner measure updated by Wacziarg and Welch (2003). It is a dummy variable, with 1 indicating fully open trade.

c. All export outcomes for sustained growth countries are averages for \(T \text{ to } T+4\).

2.38 However, the current levels of exports do not provide any indication of the potential for future growth in exports. The exports of sustained growth countries surged dramatically along with growth take-off (Figure 2-5), but Kenya's exports do not show that promise yet. While there are signs of reversal of the long decline of Kenyan exports, and diversification away from traditional products and destinations is emerging, manufacturing exports yet do not show much dynamism. In addition, exports are largely directed toward low-income neighboring countries: a feature that is an indication of lower potential for future growth, as discussed in Chapter 3.
2.39 More importantly, the explosive growth of exports in sustained growth countries was accompanied by an expanding share of world market (Figure 2-6). This indicates that exports grew at the back of improving competitiveness. This feat may not be easy for Kenya to match for at least two reasons. First, global export markets today are considerably more competitive with the arrival of China, India, and Vietnam on the scene. Second, Kenya’s performance so far has been less than encouraging. It is just coming out of a situation where its share of world exports declined for almost 20 years, after peaking in 1977-8. The good news is that the trend is positive; the decline in the share of goods exports has plateaued and is inching upward, and the share of service exports has been growing since 1999. The lesson from this discussion is that improving competitiveness must be at the center of a growth strategy that seeks accelerated global integration. It is argued later that Kenya must do what it can to improve competitiveness by reducing costs for businesses. At the same time, Kenya must take proactive steps to promote exports, including securing improved or even preferential access to the markets of developed countries.

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30 Chapter 3 examines Kenya’s export performance further.
2.40 Increasingly, evidence from successful countries suggests that real exchange rate is important to growth of exports. Literature shows that sustained growth countries maintained competitive currencies and more specifically, avoided overvaluation of their currencies (Rodrik 2007). Indonesia and Thailand actually had substantially undervalued currencies as their exports surged. Table 2-6 includes results of a simple exercise reported in Johnson, Ostry, and Subramanian (2007) that measures overvaluation as the deviation of actual real exchange rate from the one predicted by the income level of a country relative to the United States. It shows that historically Kenya had a moderate overvaluation, which persisted for a long time. Without overstressing this finding, we would like to note that pursuing a competitive real exchange rate should be a key policy objective if Kenya is to follow an externally oriented growth strategy.

2.41 In summary, Kenya’s prospects for sustained growth do not appear too constrained, when looked at from the perspective of deep determinants. In terms of geography, unexploited potential exists for Kenya to improve its external orientation. At the level of broad economic and political institutions, there is scope for further improvement, but that gap is not likely to stand in the way of embarking upon sustained growth. At the same time, a strategy to achieve sustained growth will need to focus on improving micro-level institutions related to business environment, controlling corruption, and improving security. These same micro-level institutions are also important for accelerating growth, as discussed earlier in the context of identifying binding constraints. Social fractionalization is a potential hurdle for which political solutions would need to be found and implemented over time. Kenya does not yet show the promise of dramatically increasing manufacturing exports. Improving competitiveness, including by maintaining a competitive real exchange rate, would be important to develop that promise.

Vision 2030’s Goal of a 10 percent Growth Rate—A Perspective on its Feasibility and Implications for Policy Strategy

2.42 Vision 2030 has adopted a long-term goal of achieving an average 10 percent annual growth rate. This is an ambitious goal, considering that during the 1980–2005 period, Kenya’s annual GDP growth rate was around 3 percent. To put the goal in an international perspective,
China was the only economy in the world to achieve growth rates anywhere close to 10 percent over a prolonged period in the recent history (Appendix Table A-2).

2.43 Even though the goal of 10 percent growth is ambitious, it is instructive to develop insights into what will it take to achieve it. It is done for this report by developing an analytical perspective on what combination of capital (physical and human) accumulation—financed by both domestic and foreign savings—and TFP growth would result in the desired growth rate. A dynamic-recursive Computable General Equilibrium (CGE) model is used to simulate scenarios for the economy for the period 2006–30. Appendix E describes the simulations briefly; more details are available in the background paper, Lofgren and Kumar (2007). The simulations illustrate that for the long-run growth rates that Kenya aspires to achieve, it will be necessary to make strong long-run progress along multiple fronts: raising TFP growth, attracting foreign direct investment (FDI) and foreign aid, as well as mobilizing domestic savings.

2.44 It is insightful to focus on one scenario (Scenario v30-Gradual in Appendix Table E-1) that generates an average growth rate of around 9 percent per annum for the 2006–30 period. This growth rate would result from a combination of an annual TFP growth rate of 2.6 percent and an annual increase of 6.4 percent in the stock of capital. In turn, desired growth in the stock of capital would result from a private fixed investment rate of about 24 percent of GDP by 2017 (and maintained at that level afterward). In parallel, an average public investment rate of about 5 percent of GDP would also be needed for the whole 25 years. In this scenario, investment would be financed by domestic savings, which would reach a rate of 24 percent of GDP by 2017, and external savings, at the rate of 5 percent of GDP during the entire period.

2.45 How feasible, in Kenya's context, are the “required” growth rates of TFP and capital accumulation obtained above? It is not possible to answer this question precisely. However, to get a better sense of the order of magnitudes involved here, one could compare the “required” growth rates with comparable historical rates achieved by the benchmark set of high performing economies during the period 1960–2003 (Appendix Table A-2). The table shows that with the exception of China, TFP improvement of the order of 2.5 percent per year per capita over long periods is rare. However, capital accumulation rates of about 4 to 5 percent per year were not uncommon for high performing economies. In comparison, Kenya's historical record of capital accumulation has been considerably poorer. For the entire 1960–2003 period, it averaged around 2.5 percent per year. During 1980–90 and 1990–2003, the capital stock actually shrank. This comparison exercise suggests that one way to achieve the aspired high growth rates would be to

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31 The simulations rely on a macro-oriented version of Maquette for MDG Simulations–MAMS—a model developed at the World Bank for analysis of development strategies. The advantage of using a model like MAMS for this type of analysis is that it, in a consistent and comprehensive manner, simulates the combined impact of changes in gross national savings, aid, foreign direct investment (FDI), and TFP on major economic indicators (including GDP, trade, private and government consumption and investment), considering the presence of constraints at the macro level (represented by fiscal, foreign exchange, and savings-investment balances) and in factor markets and using standard assumptions about the behavior of producers, consumers, and government.

32 For more details, see the background paper, “Kenya’s Potential for Sustained Growth: A Benchmarking Exercise” by Garrido.

33 Interestingly, during 1970–80, Kenya managed to improve TFP by an average 2.9 percent per capita per year. However, this fact is likely to be of historical interest alone and may not hold any lessons for the future because Kenya’s economic landscape, and that of the world, has changed completely since then.
accelerate TFP growth rate to about 2.5 percent per year and double the rate of capital accumulation to what it was in 1970. This clearly is a tall order.

2.46 Further, Kenya’s domestic savings rate is relatively low at 15 to 16 percent of GDP and is expected to grow slowly. A relevant question for policy makers to ask is, “Will growth be constrained by the availability of domestic savings, and should extra effort be made to bolster the private savings rate?” This report does not get into the issue of how, if at all, policy should attempt to improve the savings rate. The main reason is that policy guidance from experience elsewhere is not clear on this issue. Instead, it is suggested that areas that are more amenable to government effort—foreign aid and foreign direct investment—can be pursued more vigorously. The simulations referred to above also highlight some strategic trade-offs that are relevant to the above question about domestic savings:

- An increase in gross national savings rate from about 16 percent to about 24 percent of GDP by 2017 would require an initial slow down in private consumption growth (as a share of GDP and not in real absolute levels). Therefore accelerating savings rate involves some sacrifice up front in terms of slower pace of welfare improvement.

- FDI has the potential to increase more rapidly (and lead to more rapid technological progress) than more slow-moving domestic financing resources, and it avoids an initial slowdown in private consumption growth.

- Foreign aid relaxes the budget constraint of the government, permitting increases in domestic consumption and investment. Welfare effects are more positive than when growth is driven primarily by an increase in savings rate or FDI.

2.47 The insight from the above discussion is that at Kenya's current stage of development, achieving a high growth rate would require that the country draw upon both FDI and concessional finance in a big way. FDI flows to Kenya have been miniscule: much lower than neighboring Uganda and Tanzania (Figure 2-7). Experience elsewhere shows that FDI flows respond the most to the size of the domestic market. Therefore, FDI flows are expected to respond somewhat to increased demand for Kenyan products in the expanding regional market. Improvement in investment climate should also enable Kenya to attract higher volume of FDI flows, as would reforms to the governance and regulation of the Nairobi Stock Exchange (NSE) to enable greater use by enterprises of the equity markets. More analytical work is needed, however, to understand the behavior of FDI flows in Kenya before specific policy recommendations could be made.

34 Appendix Table A-2 provides another insight. There is no clear pattern on the relative role of accumulation versus TFP as a source of growth at different stages of growth acceleration. For the Asian economies of the Rep. of Korea, Malaysia, Singapore, Taiwan, and Thailand, a rapid accumulation played a much bigger role earlier on. In contrast, for late bloomers such as China, India, Ireland, and Mauritius, the contribution of TFP to growth appears to have been much more central.

35 All high performing economies showed improving shares of private savings and declining share of consumption in national income, with growing per capita income. The same should be expected in Kenya. In addition, restructuring of the pensions sector and reforms to strengthen the insurance sector would offer opportunities to both increase domestic savings and improve the efficiency with which those savings are intermediated.
Similarly, there is scope for aid flows to go up in Kenya, which have been stagnant at around 3 to 4 percent of GDP in the past five years (compared to 6 to 8 percent of GDP during 1980s and an all time high of 13 percent of GDP in 1990). Improvements in governance and the investment climate, combined with initial signs of success, have the potential to convince aid providers that additional aid would be put to good use. Kenya should work with aid providers to ensure that transaction costs of aid are low, that aid is predictable, and that it goes into growth priorities. Too much aid going to the services sectors would likely get in the way of maintaining a competitive real exchange rate. The trick would also be to ensure that foreign aid does not dampen revenue efforts. The caveat about the revenue effort is important because it can be plausibly argued that the motivation for fiscal reforms in the 1990s was partly the result of low level of aid.

**GROWTH STRATEGY**

Results of analysis carried out in this chapter so far provide the necessary elements of a future growth strategy. First, the experience of the past five years shows that growth in Kenya is sensitive to perceptions of business risk. Therefore, much as they initiated and fueled growth recovery, political and macroeconomic stability would also be preconditions for future growth. In the absence of political stability, businesses will make fewer new investments. Conversely, increasing political stability will further reduce political risk, thereby lowering the cost of capital for investment projects. In the absence of macroeconomic stability, there will be a tendency for economic uncertainty to increase, and with it, expectations of rising inflation and interest rates, which will slow down private investment and growth.

Fiscal policy will have an important role to play in maintaining macroeconomic stability. Kenya appears to have some fiscal space for increased infrastructure spending. The goal of fiscal policy in the next five years should be to “expand fiscal space” for infrastructure and social

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36 The priorities are best identified in an explicit and transparent manner in a medium-term plan, such as is expected to take the place of the Economic Recovery Strategy (ERS).
spending (to accelerate attainment of the Millennium Development Goals) without compromising
the solvency of public finances. To this end, Kenya should tap concessional resources for high-
return projects, improve the institutional mechanism for selecting high-return projects, and
improve the efficiency of public spending, especially in education, health, and roads. Fiscal
resources could be complemented with private resources through public-private partnership
arrangements.

2.51 If macro stability is maintained and political risk is kept low, the strategy should focus on
relaxing other constraints to accelerating and sustaining growth. In order to accelerate growth,
attention should be paid to reducing: the cost of transportation services, including logistics and
telecommunication services and improving the reliability of energy supply; reducing the costs and
risk that stem from inadequate security and corruption; and improving access to finance to small
and rural entrepreneurs.

2.52 Reduction in risk to investment through political and macroeconomic stability, combined
with reduction in costs, would accelerate growth through two channels. First, reducing business
costs would generate growth by improving productivity. The manufacturing sector would benefit
more than other sectors because infrastructure-related services are a bigger component of total
production costs in manufacturing. Second, reduced costs and risks would improve incentives to
invest by raising the return on capital, not only for domestic investors but for foreign investors as
well. FDI would go up as the public infrastructure, crime, and security situation improve.

2.53 Reducing business costs would also help enhance international competitiveness of
tradable goods and services, and thereby improve Kenya’s integration into the global trading
system. The impact on competitiveness of the tradable goods sector would be direct through
reductions in total production costs. The impact on competitiveness of reduced costs in non-
tradable sectors would be indirect, through reduced price of services for the whole economy.
More specifically, reducing internal transportation costs would help development of natural
resource–based exports, and reducing maritime transportation costs would increase opportunities
for Kenya to participate in global production chains.

2.54 Improved global integration would have a dynamic effect on the productivity of Kenya’s
private sector. Exporting would help the private sector become more dynamic and further
improve productivity. Increasing FDI would bring with it newer technology, newer products, and
help improve productivity, as happened in the horticulture and garments sectors. Indeed, Kenya is
likely to rely considerably for its productivity growth on technological change embodied in new
investment. Lastly, FDI is likely to be a source of access to other markets, particularly in niche
products, as has happened in East Asia.

2.55 Arguably, Kenya could do more to accelerate integration of the country into the fast-
growing global economy, which is being driven by historical flows of goods, services, and
finances. Kenya’s advantageous geography (coastal location and natural beauty) and skilled
English-speaking labor force makes it well placed to follow such a strategy. Potential exists both
in global and regional markets and in traditional and nontraditional products. Realizing this
potential would require orchestrating other policies—general and sector/industry-specific—
toward creating a commercial environment conducive to increasing investment (both domestic
and foreign) and improving competitiveness even further.

2.56 Trade policy would be an important component of such a strategy. Kenya’s exports to
neighboring countries have expanded in the past few years. Regional trade will therefore remain
important. Deepening of regional integration is also desirable because regional trade helps in
integrating fragmented markets, allowing economies of scale and helping in developing new
exports to third markets. However, there is a limit to regional trade because the countries in
the region have similar resource endowments and produce similar products (lack of
complementarities). Therefore, the Kenyan growth strategy would need to push and help the
private sector in enhancing its competitiveness beyond the East Africa region. This would include
further trade liberalization and improved trade facilitation, among other policy actions.

2.57 While deepening regional integration, Kenya would need to continue its efforts to secure
access to markets outside the region, particularly in Asia. Securing access to markets would also
promote FDI—essential for product diversification and productivity improvement—since
uncertainty about markets inhibits FDI. Kenya has recently signed an interim Economic
Partnership Agreement (EPA) with the European Union (EU) jointly with its partners in the East
African Community. Kenya will need to continue negotiations with the EU in 2008 for a full EPA
and participate effectively in multilateral negotiations. The multilateral route would be better for
getting access to Asian markets.

2.58 A sector/industry-specific approach to addressing binding constraints could complement
the general economy-wide actions discussed above. The objective of government involvement
would be to try to identify sector-specific issues—such as government-market failures—and
provide solutions, in close dialogue with industry groups and associations, to recover, maintain,
or improve Kenya’s competitive position. These industry-specific issues could relate to
competition, regulation, government policy, bottlenecks in supply chain, information gaps,
coordination failures, and the like. The solutions to identified issues would often be in the form of
policy fine-tuning, improving coordination through institutional changes, and so on. Such an
approach could be used for both traditional sectors and nontraditional, natural resource–based
industries in which there is potential for growth and poverty reduction. Vision 2030 identifies
manufacturing, high-valued services based on Internet, and tourism as areas where a
sector/industry lens could prove useful.

2.59 Maintaining a competitive real exchange rate would also be an integral component a
strategy aimed at faster global integration. Many of the policy actions discussed earlier would
help keep the real exchange rate competitive. For example, an improvement in productivity in the
services sector through reduction of costs would help maintain competitiveness. Similarly, further
trade liberalization would help through increased imports. This report would caution against
active attempts to manage the nominal exchange rate. More analytical work needs to be done to
identify various policy levers that could help in maintaining a competitive real exchange rate.

2.60 The growth strategy above implies a strong positive and enabling role for the
government.

- Improving the investment climate and adopting appropriate trade policy to enhance
  competitiveness is largely in the domain of the government. The government has
  made a good beginning in identifying regulatory hurdles and streamlining
  administrative processes faced by the businesses. Substantial and lasting benefits will
  accrue only if these reforms are deepened. Some sectors could also benefit from
  sector-specific policy actions.

- Managing public finances to create fiscal space for social spending and
  infrastructure spending without compromising the solvency of public finances is
government’s job. The challenge before the government is to put a system in place
for selecting projects and programs with high rates of return and improving the efficiency of spending in the ministries of education, health, and roads.

- Pursuing an implementation/results orientation in the public sector would be critical to success of the growth strategy. The government has been successful in the past two years in improving focus on results. Yet an inordinate amount of government time continues to be devoted to preparing and discussing comprehensive strategies and plans. While short and sharply focused studies may be needed in some areas, attention should shift to implementing plans and finding pragmatic solutions to immediate issues and problems at hand.

- Improving policy coordination in the government would be important for trade and tourism. In both these areas there are a large number of agencies with overlapping mandates.

- Deepening civil service capacity would improve implementation. This does not necessarily mean higher wages for top civil servants. Instead, it could mean developing a cadre of qualified senior civil servants with well-defined career succession plans.

- Establishing strong feedback mechanisms to improve implementation and fine-tune policy. Feedback mechanisms are not only about collecting good quality information, but also about making changes to policy in response. They also include evaluation of government programs and two-way open communication with the private sector.

2.61 Above all, the growth strategy should be part of politically shared development strategy. The Vision 2030 process has created a political convergence of sorts on the development strategy. It remains to be seen how robust it is to alternative leadership. Continuing efforts to strengthen political stability (including avoidance of scandals) is critical.

How to Implement the Growth Strategy—A Roadmap to the Rest of the Report

2.62 The rest of this report selectively drills down into some key areas of the growth strategy outlined above. Chapter 3 examines the elements of competitiveness, discusses export performance, and elaborates on trade policy, including trade facilitation, and sector-specific and industry-specific approaches to accelerate global integration. Chapter 4 delves into the details of how the performance of port, roads, and telecommunications sectors can be improved. Chapter 5 discusses actions to orient fiscal policy toward growth objectives. Chapter 6 focuses on the issue of mobilizing private resources for infrastructure.
3. ENHANCING GLOBAL INTEGRATION AND EXPORT DIVERSIFICATION

3.1 The growth strategy presented in Chapter 2 emphasized the need for Kenya’s economy to get more globally integrated. This chapter provides more details about Kenya’s competitiveness at both macro and micro levels in order to inform policy actions. Evidence on investment climate is brought to bear from ICA 2007. Export outcomes are then reviewed from several angles, such as growth potential, dynamism, and sophistication, and recommendations for trade policy are offered.

KENYA’S GLOBAL COMPETITIVENESS

3.2 International competitiveness refers to a broad assessment of economic performance relative to other similar countries. Narrower measures, such as price or cost competitiveness, are used in macroeconomics, such as price or cost competitiveness. The real exchange rate is often used as a medium-term measure of price competitiveness since it measures the ratio of prices of the goods and services that one country produces relative to that of its trading partners. A depreciation of the real exchange rate is seen as an improvement in competitiveness since it is easier to sell domestic goods to partner countries. Kenya’s real effective exchange rate (REER) and nominal effective exchange rate (NEER) have both appreciated since October 2004 (Figure 3-1). REER has appreciated more (24 percent) than the NEER (18 percent) because inflation has been higher in Kenya than in trading partner countries.

![Figure 3-1: Real and Nominal Effective Exchange Rates (Oct. 1997 = 100)](source: IMF (2007)).

37 Nonfood CPI is used to calculate REER.

38 The REER, measured using relative price levels, would be expected to appreciate in a country where unit labor costs in traded goods are falling more rapidly than in competing economies. Thus, despite the appreciation in REER, competitiveness could be maintained. To some extent, this appears to have been Kenya’s experience in the past four years from 2004 to 2007.
3.3 The unit labor cost by itself is often used as a measure of cost competitiveness. It is obtained by dividing labor cost by output per worker. An improvement in labor productivity that is not matched by an increase in labor costs (wages plus other labor-related costs to the employer) implies a fall in unit labor cost and an improvement in competitiveness. Unit labor costs can be measured at an economy-wide aggregate level as well as at an individual business level. Figure 3-2 presents average unit labor cost data for several countries, based on investment climate assessments conducted by the World Bank and partner organizations. Unit labor costs in Kenya in 2007 were only slightly higher than India and were lower than Tanzania and Uganda. Between 2002 and 2006, unit labor cost fell in Kenya because of increased productivity, without corresponding increase in real wages. While this shows that Kenya’s competitiveness has improved, it should be noted that unit labor costs have fallen far more substantially in China, India, and Tanzania. In Uganda, on the other hand, unit labor costs increased marginally between 2002 and 2005.

Figure 3-2: Unit Labor Costs, Kenya, Tanzania, Uganda, China, and India

Source: Staff calculations based on ICA surveys, various years and countries, World Bank.

Recent Evidence on Investment Climate in Kenya

3.4 The investment climate refers to government policies and behaviors that shape opportunities and incentives for firms to invest. Specifically, measures of costs, operating risks, and barriers to entry faced by a firm are used to assess how conducive the investment climate is.

39 Empirical literature presents evidence that a decline in the unit labor cost is associated with an increase in the export share of the country.

40 This observation is consistent with previous evidence on labor costs in the garment industry (Cadot and Nasir 2001) that Kenya, along with other countries such as Ghana, Lesotho, Madagascar, and Mozambique, is competitive in shop floor productivity of labor once wages are taken into account.

41 A decrease in unit labor cost implies that at the firm level, total labor compensation did not increase in the same proportion as the total value added.
for the private sector. A poor investment climate as a result of policy uncertainty, macroeconomic instability, corruption and high infrastructure costs was widely associated with the decline in the Kenyan economy during the 1990s and was found to be a major obstacle to growth and competitiveness in the early part of this decade (World Bank 2004).

3.5 Kenya’s performance on cross-country measures of the investment climate suggests considerable potential for improvement. The “Doing Business 2008” report (World Bank 2007e) highlights Kenya’s ambitious licensing reform program aimed at streamlining business startup, and cutting both the time and costs of getting building permits. The report recognizes Kenya as one of the ten best reformers in 2007, yet it ranks only seventy-second out of 128 countries on the Ease of Doing Business Index. Appendix Figure A-2 shows that paying taxes, trading across borders, registering property, and enforcing contracts are seen as areas that are more problematic.

3.6 Kenya is ranked ninety-ninth (out of 131 countries) on the World Economic Forum’s Global Competitiveness Index (GCI). The survey identifies the areas of corruption, inadequate supply of infrastructure, access to financing, tax rates, and crime and theft as the most problematic factors for doing business (Appendix Figure A-3). On the other hand, innovation, business sophistication, FDI and technology transfers, education expenditures, legal financial rights, labor costs, and hiring and firing practices are noted as areas of notable relative competitive advantage.

3.7 The recent World Bank investment climate survey (ICA 2007) confirms that Kenya’s investment climate has improved in general since 2002. This is true in terms of perceptions as well as objective data, such as on business costs and losses (Figure 3-3). The improvement is significant along the dimensions of macro and political stability and availability of factors (land, labor, finance). For example, more than half the manufacturing firms that had identified macroeconomic and political stability as a serious constraint to business switched their perception in 2007.

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42 In 2006/7 the government launched an ambitious licensing reform program, which has led to the elimination of 110 business licenses and the simplification of eight, reducing the time and cost of obtaining building licenses and registering a company. At the end of the program, it is anticipated that more than 600 of the 1,300 licenses will be simplified or eliminated. In addition, introducing competition among land valuers (allowing private practitioners) has cut the time needed to complete land valuation from one month to one week. The licensing reform program is still far from complete and needs to be deepened for it to have an impact on private sector’s costs.

43 World Economic Forum (2007). The GCI survey includes ratings for corruption, infrastructure, and the like, which the Doing Business survey does not. That could explain the relatively lower rank.

44 Investment climate variables (as referred to in World Bank surveys) variables overlap significantly with Doing Business Indicators, but include additional questions on infrastructure costs and political and macroeconomic risks. They also include information on perceptions of business owners beyond objective quantitative data.
3.8 In all the surveys discussed above, the private sector has repeatedly identified poor and costly infrastructure services as the binding constraint on business. In ICA 2007, 47 percent and 55 percent of businesses consider transportation and electricity, respectively, as a major obstacle. Importantly, of all the manufacturing firms that were surveyed in both periods, an additional 12 percent considered infrastructure services (transport or electricity) to be a major obstacle in 2007 compared to 2002. As expected, manufacturing firms (including agribusiness) are more severely hurt by poor infrastructure services than other businesses. On average, transport costs are about 10 percent of non-factor costs (excluding the cost of materials) of manufacturing firms in 2007.45

3.9 From the point of view of competitiveness in international trade, it is more instructive to examine performance of trade logistics as a package. For trading firms competing globally, overall reliability of the supply chain is critical. This includes customs procedures, logistics costs, ability to track and trace shipments, timeliness in reaching the destination, and the efficiency of domestic logistics. Kenya ranks 76 out of 150 countries on the Logistics Performance Index, recently released by the World Bank. In comparison, South Africa ranked at 24, China at 30, and India at 39. Kenya’s rankings on the competence of public and private logistics service providers, domestic logistics costs, and transport infrastructure are particularly low and highlight the need for priority attention to these areas. The next chapter returns to the subject of transport logistics to identify a policy agenda for reform.

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45 There is significant regional variation in perceptions about infrastructure services as a constraint. Firms outside Nairobi find infrastructure services a bigger hindrance to doing business. Costs of infrastructure service inputs (electricity, transportation, and water) outside Nairobi represent 35 percent of total nonfactor costs, excluding materials, compared with 24 percent in Nairobi (without controlling for firm characteristics).
3.10 Cost of energy inputs continues to be cited as a major competitiveness issue by manufacturing firms. Power outages increased from an average of 16.4 hours per month in 2002 to 24.5 hours in 2006, with perceived losses of 7.1 percent of sales in the latter year.

3.11 Crime, theft, disorder, and corruption remain serious constraints to doing business. Some 54 percent of firms reported corruption, and 58 percent of firms reported crime, as a major or very severe constraint to doing business in ICA 2007. Cross-country comparisons show that losses and costs due to crime, security, and corruption remain high. Estimated losses on these counts add up to 10.4 percent of sales in Kenya compared to 1.8 percent in South Africa, 2.9 percent in Senegal, and 3.6 percent in India (Table 3-1). Managers participating in government procurement report that informal payments can be as high as 12 percent of the contract value (ICA 2007).

Table 3-1: Direct Costs of Weak Security and Bribes to Formal Firms, Cross-country Comparison

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<tbody>
<tr>
<td>Crime</td>
<td>3.9</td>
<td>0.3</td>
<td>0.2</td>
<td>0.6</td>
<td>1.0</td>
<td>1.1</td>
<td>1.0</td>
</tr>
<tr>
<td>Cost of security</td>
<td>2.9</td>
<td>0.8</td>
<td>1.3</td>
<td>0.9</td>
<td>1.5</td>
<td>2.3</td>
<td>1.4</td>
</tr>
<tr>
<td>Bribes</td>
<td>3.6</td>
<td>1.9</td>
<td>2.1</td>
<td>0.3</td>
<td>0.4</td>
<td>3.4</td>
<td>3.7</td>
</tr>
<tr>
<td>Total costs*</td>
<td>10.1</td>
<td>2.0</td>
<td>3.6</td>
<td>1.8</td>
<td>2.9</td>
<td>6.8</td>
<td>6.1</td>
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*Adding up in each column is for illustration only. Strictly, average of costs cannot be added.

3.12 The perceptions of Kenyan firms about the tax burden are negative. ICA 2007 finds that almost 60 percent of surveyed businesses identified tax burden as a major constraint to business. Objective indicators of fiscal pressure reported in the “Doing Business 2008” report suggest the Kenya’s tax burden is higher than most comparator countries (Figure 3-4). This finding begs more analysis because Kenya’s tax rates are comparable to neighboring countries (Appendix Table A-4). The burden of paying taxes is relatively high though. Experience elsewhere suggests that negative perceptions about the tax burden could be rooted in unreliable and costly public services. Given these perceptions, further analysis may be needed to establish if tax levels constrain new investment or create large distortions otherwise. At the very minimum, the government should make sure that earmarked tax revenues such as the road levy or the sugar levy are efficiently spent for the purposes for which they are collected. In addition, a simple and predictable tax environment that reduces the cost of compliance with tax obligations is desirable.

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46 These figures were higher in 2003.

47 The “Doing Business 2008” report measures Kenya’s tax burden as 50.9% of gross profits. This burden includes the following: fuel tax (0.02), land rent (0.02), financial transactions (0.03), land rates (0.30), road maintenance levy (0.42), excise on fuel tax (0.48), business license (0.84), apprenticeship tax (1.52), manufacturing tax (4.21), NSSF (5.25), standards levy (5.30), and corporate income tax (32.53). It should be noted that Kenya’s tax rates are comparable with other EAC and comparator countries in SSA.
3.13 *Access to finance* (availability and cost) has improved between 2003 and 2007, yet it was cited as major or severe obstacle to doing business by about 42 percent of firms in the ICA 2007. The problem is more severe for smaller businesses. About 76 percent of microenterprises considered access to finance a serious constraint. One reason for these perceptions appears to be the high cost of collateral requirements in Kenya. The median firm posts 120 percent of the loan amount as collateral. This discourages firms from applying for loans. Microenterprises are less likely to meet the collateral requirements than larger enterprises. Some 43 percent of microenterprises (out of a sample of 92) reported that they did not apply for a loan because collateral requirements were high. The reason for conservative lending practices appears to be that the law is restrictive in what can be used as collateral. On average, the value of the required collateral represented 125 percent of the credit line or loan.\(^{48}\)

3.14 Informality also significantly restricts access to finance. Importantly, some kind of legal status (such as registration of company name, commercial registration, an operating or trade license or a general business license, or a tax identification number) is highly correlated with access to finance. Nearly 35 percent of microenterprises that had some legal status had access to external credit, compared to only 4 percent of nonlegal enterprises. Apparently, a legal status is a signal of firm quality to the lender.

3.15 Evidence from another source—the Financial Access Survey 2006 (FAS—conducted by Financial Sector Development Trust, Kenya) finds that access to credit depends on geographic location of businesses as well. It shows that access to credit declines as one goes from urban to rural to arid to semi-arid areas. It may partly be due to the density of branch network in different areas. Over 90 percent of Kenya’s bank branches are in urban and rural districts. Branches in semi-arid districts account for 4.7 percent of the national total, while those in arid districts account for 2.8 percent. Appendix C contains more findings of the FAS.

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\(^{48}\) Some 60 percent of manufacturing firms applying for a credit line or for a loan with financial institutions were required to post collateral based on their land, buildings, machinery, and equipment. Some 38 percent were required to post account receivables and inventories; and 15 percent were required to post personal assets of the owner.
3.16 Historically Kenya’s export performance has been below its potential despite some notable achievements. The World Bank (2007a) report carried out a detailed review of Kenya’s export performance over the past three decades (Box 3-1) and made recommendations to accelerate diversification of exports. The following paragraphs extend the analysis of the 2007 report to a more recent period and introduce newer tools of analysis to get a sense of future prospects.

**Box 3-1: Historical Performance of Kenyan Exports**

In several areas, Kenya’s exports have done very well over the past two decades. Kenya has built a competitive supply chain based on its comparative advantage as an off-season producer in cut flowers and fresh fruits and vegetables. Exports of cut flowers and fresh vegetables to the EU grew at annual rates close to 10 percent between 1995 and 2003. The country is now Africa’s biggest grower of cut flowers and one of Africa’s largest exporters of fresh horticultural produce. Horticulture exports comprise approximately 27 percent of Kenyan exports. In the apparel sector, Kenyan exporters were able to take advantage of preferences provided by the African Growth and Opportunity Act (AGOA). Apparel exports also grew two hundred-fold between 1976 and 2003. The tourism industry boomed after the U.S. and UK travel bans were lifted, and total tourism receipts were estimated at more than US$750 million in 2006.

Overall, however, Kenyan exports have stagnated until recently. Between 1980 and 1985, Kenya supplied 0.65 percent of world trade; by 2003, its share of trade had declined to less than half of that, although Kenya maintained its share of the manufacturing market. Between 1980 and 2003, Kenya experienced diminished competitiveness in many of its exports, coffee being a notable example. While Kenya has expanded its nontraditional natural resource-based exports, a significant share of exports are still agricultural commodities (mainly coffee and tea), for which prices have shown declining trend. Yet natural resource-based exports, in which Kenya has a comparative advantage, are expected to continue to be the mainstay of its trade for quite some time.

*Source: World Bank (2007a).*

3.17 In the past few years, important changes have taken place in Kenya’s exports in terms of the pace of growth, the commodity composition, and the relative importance of trading partners, all indicating that the chronic decline in Kenya’s exports since the early 1980s could have ended and a process of renewal is emerging (Table 3-2) records recent trends in Kenyan exports. Since 2001, Kenya has experienced export growth for six consecutive years, averaging 15.1 percent a year. This constitutes a significant pick up compared to an average 1.8 percent in the previous six years. Exports of both goods and services have grown. Kenya’s exports of services grew at a rate of 16.3 percent per year between 2000 and 2006.49 The goods exports-to-GDP ratio has improved, averaging about 17 percent in the six years since 2001, compared with 15.5 percent for the previous six years.

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49 All components of service exports contributed to this dynamic behavior. Annually, transportation services grew at 16.4 percent, telecommunication services grew at 56.1 percent, and travel and government export services grew at 15.1 and 9.2 percent each during this period.
Table 3-2: Recent Trends in Kenyan Exports (all numbers in percent)

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</thead>
<tbody>
<tr>
<td>Annual change in the value of Total goods exports</td>
<td>12.8</td>
<td>9.8</td>
<td>-2.7</td>
<td>-1.8</td>
<td>5.8</td>
<td>-13.1</td>
<td>6.4</td>
<td>14.5</td>
<td>12.1</td>
<td>31.0</td>
<td>14.5</td>
<td>12.1</td>
</tr>
<tr>
<td>Annual change in the value of Non-oil goods exports</td>
<td>--</td>
<td>8.6</td>
<td>-5.4</td>
<td>-1.1</td>
<td>7.9</td>
<td>-13.4</td>
<td>5.8</td>
<td>4.9</td>
<td>5.7</td>
<td>9.1</td>
<td>35.2</td>
<td>--</td>
</tr>
<tr>
<td>Annual change in the value of oil exports</td>
<td>--</td>
<td>29.4</td>
<td>33.3</td>
<td>-9.1</td>
<td>-15.6</td>
<td>-8.1</td>
<td>13.7</td>
<td>132.6</td>
<td>47.6</td>
<td>25.8</td>
<td>16.6</td>
<td>--</td>
</tr>
<tr>
<td>Annual change in the value of services exports</td>
<td>--</td>
<td>-8.7</td>
<td>-2.4</td>
<td>-9.2</td>
<td>12.7</td>
<td>6.2</td>
<td>12.8</td>
<td>3.0</td>
<td>3.8</td>
<td>30.0</td>
<td>21.0</td>
<td>--</td>
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<tr>
<td>Share of goods exports in GDP</td>
<td>18.2</td>
<td>16.7</td>
<td>14.9</td>
<td>13.6</td>
<td>15.7</td>
<td>13.9</td>
<td>14.2</td>
<td>16.6</td>
<td>16.4</td>
<td>16.7</td>
<td>18.5</td>
<td>19.6</td>
</tr>
<tr>
<td>Share of goods exports in world exports</td>
<td>0.038</td>
<td>0.036</td>
<td>0.035</td>
<td>0.035</td>
<td>0.036</td>
<td>0.028</td>
<td>0.030</td>
<td>0.033</td>
<td>0.032</td>
<td>0.030</td>
<td>0.034</td>
<td>0.035</td>
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</table>

Source: IMF Balance of Payments Statistics, UNTRADE.

1. Oil refers to petroleum products exported to neighboring countries.
   -- not available.

3.18 Product composition has also changed. The combined share of the traditional export items such as tea and coffee fell from 35.4 percent of total exports to 18.5 percent from 1995 to 2006. The share of petroleum products climbed from 7.1 percent to 24.1 percent during the same period. While product diversification has taken place, export concentration has increased—reflected in the share of largest five export items in total exports, which has increased from 51.9 percent to 58.3 percent since the mid-1990s (Appendix Table A-4).

3.19 The “discovery” of new products appears to have stalled, however. In the past, Kenya had discovered several new products such as cut flowers and horticultural products. However, in the 2000 to 2005 period while Kenyan exports gained world markets share in certain products such as fresh horticultural and floricultural products, garments, and fish, there were no new lasting “discoveries.” In comparison, Uganda has discovered 97 nontraditional products between 1976 and 2004, which accounted for 40 percent of Uganda’s overall export basket from 2001 to 2004 (World Bank 2007j).

50 The increased share of energy-product exports is the result of increased domestic capacity to refine foreign-produced crude petroleum. Most of this is destined for Uganda and Tanzania.

51 “Discovery” refers to a situation in which a country produces and develops export capability for a product that is new to the country, but not necessarily new to the international market. The methodology of Klinger and Lederman (2004) is used to identify discoveries for the 1969–2005 period using COMTRADE data. A new product (discovery) is recorded when the ten-year average exports (up to year “t”) jump from less than US$10,000 to more than US$1 million per year in year t+10 (10 years later). Lowering the threshold for the jump of exports to US$500,000 yields two new products: “unmilled barley” and “chocolate and other food preparations containing chocolate.” A similar methodology and criteria to that used to identify product discoveries was used for country discoveries.

52 Following Klinger and Lederman (2004), one can find isolated discoveries in the 2000s, such as fats oils from fish, fuel wood, coal, and yarn of regenerated fibers in 2001; and tin and tin alloys in 2002. However, these discoveries did not last, as their export value in U.S. dollars has fallen in subsequent years.
3.20 The good news though is that exports have become more diversified in terms of destination countries. Kenya has “discovered” a handful of new export destinations, both within and outside the SSA region. New export destinations for Kenya outside SSA include Belgium, Kazakhstan, Luxembourg, Poland, and Russian Federation.

3.21 Despite the discoveries, Kenya is in the midst of a long-term trend of exporting more of its goods to low-income countries. This shift has occurred as Kenya’s trade with the EU has shrunk, while its trade within the East African Communities (EAC) and the Common Market for Eastern and Southern Africa (COMESA) has expanded (Figure 3-5). There is further scope for Kenya to expand its regional trade, particularly in commodities such as maize, dairy, processed food, and cotton and cotton products following the expiration of a provision in the AGOA allowing the use of third-party fabrics. However, the growth potential for regional trade in finished goods is limited because countries in the region have similar resource endowments producing similar products (low complementarity). An important implication of this view is that the primary objective of regional integration for Kenya should be to improve competitiveness by integrating fragmented markets. Regional integration should be seen as a stepping-stone to greater integration in the world economy, rather than expanding regional trade.

![Figure 3-5: Kenya’s Exports by Income Level of Destination Countries, 1980-2005](image)

Source: Staff calculations, based on COMTRADE data.

3.22 Digging deeper into the structure of Kenya’s exports produces some more positive news. One approach is to look at the revealed comparative advantage (RCA) of goods in Kenya’s export basket between two periods, 1980–85, and 2000–05.53 Between these periods, Kenya managed to gain comparative advantage in the export of 20 groups of exportable products, representing almost 28 percent of the country’s average exports from 2000 to 2005. Main examples are outer garments, metal equipment, iron sheets, fish products, and sugar confectionary. During the same period, the country maintained its RCA in 14 groups of products that contributed over 55 percent of goods exports from 2000 to 2005. Importantly Kenya did not lose RCA in any of the groups of exports. Products in which Kenya did not have a RCA in either of the two periods represented a

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53 Balassa’s concept of RCA is used. A country has RCA in a product if the share of that product in the country’s total exports exceeds the share of the product in total world exports. This is the same as saying that the share of a country’s exports in the world exports of a product exceeds that country’s share in total world exports.
small 12 percent of Kenya’s exports from 2000 to 2005. (Appendix Table A-5 lists each category of products.) This analysis suggests that generally Kenya is adding to the list of products in which it has comparative advantage while maintaining its strengths.

3.23 Another summary way to look at Kenya’s export package is to use the EXPY index suggested by Hausmann and Klinger (2006). The EXPY index constitutes a proxy for the degree of sophistication or productivity that an economy achieves because of the process of discovering new products by entrepreneurs. By definition, richer countries would have higher EXPY, and a progression over time would indicate change in sophistication of a country’s export package. Figure 3-6 plots EXPY progression for a selected group of countries. It can be seen that Kenya’s level of EXPY is low, which indicates that Kenya’s exports are largely poor countries’ exports. The good news is that EXPY appears to be improving since 1998/99.

Figure 3-6: EXPY (proxy for degree of sophistication), High Performing Countries and Kenya, 1992–2003

3.24 What is Kenya’s potential to develop comparative advantage in products with higher sophistication? In recent research, Hausmann and Klinger (2006) have proposed that the probability of developing RCA in a particular good in the future is affected by the ease with which the current capabilities in the economy can be adapted to the new product. In other words, the “proximity” of a new product to the country’s current export basket will matter. A “new” product with higher proximity to the country’s export basket and with higher income value (as measured by PRODY) will be more likely to attract entrepreneurs’ attention and the country is likely to develop RCA in those products in due course. Indeed, in Kenya, between 1980–85 and 2000–5, several products with higher PRODY and higher proximity to the export basket in the

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54 EXPY is an indicator that measures the income levels associated with a country’s export basket. It is calculated as the weighted average of the country’s implicit export basket income, using as weight the shares of each product in the country’s export. In turn, each exportable product income (PRODY) is calculated as the weighted average of incomes of countries exporting that product, using as weight the revealed comparative advantage of each country in the product. See Hausmann and Klinger (2006) for details.

55 This, in a way, suggests the process of structural transformation and growth. Resources will move from products with low PRODY to high PRODY, producing a shift in the country’s production basket.
1980–4 periods have become products with RCA in 2000–4. This highlights a certain amount of dynamism in the Kenyan production—and hence export—basket; Kenya appears to be moving toward higher value products.

3.25 Extending the methodology discussed above, it is apparent that Kenya has the potential to develop comparative advantage in several “new” products. Specifically, products that today show a combination of high density or proximity and high income value (PRODY) and that are currently not exported, or are exported in relatively small amounts, constitute the candidates for developing future RCA. Such products include: fish and its preparations; essential oils and toilet articles; manufactures of metals; paper, paperboard, and articles of paper; resins, cellulose, and plastic materials; and edible products and their preparations (Figure 3-7).

Figure 3-7: Measure of Proximity to Current Export Basket (Ease to Adapt), Income Value (PRODY), and Export Values of Products with RCA, Kenya, 2000–4

Source: Staff calculations, based on COMTRADE.
Note: The size of the circles represents the share of exports of the product in total Kenya exports. PRODY is a measure of the weighted income level of countries exporting that product. Density is a measure of the ability of the economy to produce and export a given product (in other words, of the proximity of the product to the country’s export basket).

3.26 More evidence of dynamism is that Kenyan firms are investing in innovation. Over the last three years, two-thirds of all manufacturing firms reported having introduced a “new or significantly improved process of production” and 57 percent reported having introduced technological innovation (ICA 2007). These data suggest a higher rate of innovation than that reported in other African countries by Bigsten and Soderbom (2006). Figure 3-8 shows the
sources of technological information and innovation reported by manufacturing firms in ICA 2007.

**Figure 3-8: Sources of Technological Information and Innovation**

- Embodied in new equipment
- By hiring key staff
- Domestic licensing
- From parent company
- In collaboration with client firms
- International licensing
- In collaboration with supplier of equipment
- Developed locally
- Other


### Improving Global Integration

3.27 As the preceding discussion indicates, there are several positive aspects to Kenya’s recent export performance. Apart from the growth of exports, which is showing some dynamism, the product and country composition of exports is also changing toward a more balanced mix in terms of traditional and manufacturing products, as well as high- and low-income trading partners, ensuring a broader base for an export-led strategy. The RCA analysis shows that Kenya continues to have comparative advantage in a large number of resource-intensive and labor-intensive subsectors in agriculture, manufacturing, and services. In addition, EXPY analysis provides signs of improving sophistication of output mix. Overall, it appears that serious opportunities exist for Kenya to accelerate export growth. In terms of products and markets, these opportunities are in the following areas:

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56 This section draws considerably upon World Bank (2007a), which carried a detailed review of Kenya’s trade policy and institutions. The paragraphs that follow highlight and update key recommendations of that study. This discussion still leaves out institutions and policies for export promotion, such as export processing zone (EPZ) schemes. Export promotion is an important topic for further analysis.
- **Increasing exports of existing products in existing markets** A good example is increasing garments exports in the EU market to take advantage of the recent improvement in the rules of origin agreed as part of the interim Economic Partnership Agreement (EPA). Under the new “single transformation” rule, the EAC countries can export garments to the EU made from cloth imported from any country. This important market access opportunity would allow Kenya to intensify its penetration in the EU and repeat its success in garment exports to the United States under AGOA.

- **Expanding the range of markets into which existing products are sold.** Recent experience show that this opportunity exists both in the industrialized countries (horticulture and floriculture) and in low-income countries in the region (labor-intensive manufactures). Fast-growing emerging economies such as Brazil, China, and India can also be targeted to export existing products (World Bank 2007b).

- **Upgrading the quality of the existing products and/or adding further value to these products.** This would apply particularly to food processing—and moving up in the value chain, to textiles and garment products. For example, options should be explored to repeat the success in exporting fish fillets instead of frozen fish.

- **Taking advantage of opportunities to expand exports of services.** Opportunities exist especially in the tourism, financial, and off-shoring services, to serve global as well as regional markets. Recent performance shows recovery in exports of services.

- **Producing parts and components as part of global production and trading networks.** Kenya should explore both the global and regional markets in these new dynamic areas of trade (World Bank 2007a).

- **Introducing new products (discovery)** These products would likely be new to Kenya. As discussed, during the past 25 years, Kenya has developed a number of "emerging products" where it demonstrates RCA (20 products at the three-digit level, constituting 27.6 percent of Kenya’s exports in 2000–05).

3.28 How can these opportunities be exploited? A mix of policy actions will help the private sector exploit these opportunities. Foremost among these are the actions that would cut costs identified in the previous section and improve global competitiveness of the Kenyan businesses. Chapter 4 lays out the policy agenda for reducing the cost of backbone services in transport and telecommunications. The final part of this chapter discusses actions in two other areas to improve competitiveness: trade policy, including trade facilitation and trade policy coordination; and sector/industry-specific actions.

**Trade Policy and Trade Facilitation Actions**

3.29 Kenya should use its membership in regional trade groups—EAC and COMESA—to consolidate further trade openness, with a view to enhancing its competitiveness rather than securing trade-diverting preferences. Within EAC, the priority for Kenya is to push for the completion of the full EAC free trade area (FTA). This would require elimination of the remaining nontariff barriers (NTBs) on intra-EAC trade and liberalization of the backbone services (transport, telecommunications, and finance) in the EAC zone. In the medium term, the EAC will need to reduce tariff protection further by cutting the maximum common external tariff (CET) and its exemptions, improving and harmonizing the business environment to establish a
common market, and reducing the role of internal border posts to consolidate the EAC customs union. The scheduled CET review in 2009/10 will offer an opportunity to reduce the maximum CET rate, simplify the exceptions regime, and reduce tariff variation and escalation.

3.30 COMESA is a significant and growing market for Kenya, constituting over 30 percent of its total exports. Within COMESA, the priority is to deepen the free trade area by eliminating non-tariff barriers on intra-COMESA trade, and harmonizing and improving customs procedures and transit policies. The medium-term measures include liberalization of the backbone services and harmonization of the behind the border policies such as the investment code and competition policy to make the COMESA zone an investment destination.

3.31 In areas where Kenya cannot move speedily enough through these trade groups, it should move unilaterally with an eye on global competitiveness beyond the borders of regional partners. Further liberalization in telecommunications (discussed in Chapter 4) and financial services can be carried out unilaterally. The variable geometry principle (the idea that not every country need take part in every policy but some can cooperate more closely) included in the EAC and COMESA agreements allows Kenya to move faster in these areas, with the expectation that other members would catch up and the policies would be harmonized later.

3.32 Equally important is securing access to export markets. As noted earlier, Kenya, together with its EAC members, has signed an interim Economic Partnership Agreement with the EU. Negotiations will continue toward a full EPA in 2008. Among the issues yet to be negotiated are trade in services, rules of origin, and competition policy, which are critically important for Kenya. Together with its EAC partners, Kenya needs to prepare for these negotiations and conclude a full EPA in 2008.

3.33 The outcome of the Doha Round of negotiations is important for Kenya, given the increasing geographic diversification of its exports. Kenya’s interests in these negotiations include substantial reduction in agricultural protection, and tariff peaks and escalation in manufacturing, both in the industrialized and emerging market economies. The multilateral route may also be the best route to negotiate market access to dynamic Asian markets, where Kenyan products face high tariff barriers.

3.34 Compliance with food safety and agricultural health standards has been an important factor driving Kenya’s diversification into such nontraditional exports as horticulture, cut flowers, and to a lesser extent, fish. Public-private partnerships in these sectors, encompassing a suitable regulatory framework and the broad adoption of good agricultural and manufacturing practices, should serve as an example to other industries. The development of such systems is crucial if

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57 Kenya (together with Burundi, Rwanda, and Uganda) recently agreed to a COMESA CET, which will be launched in December 2008. This clearly conflicts with its commitment to the EAC CU and does not seem to be in the trade interests of Kenya. It would therefore appear advisable for Kenya (and other EAC members) not to participate in the COMESA CET.

58 The Agreement allows 100 percent liberalization by value by the EU as of January 1, 2008 (with transition periods for rice and sugar) and 82 percent liberalization by value by the EAC (64 percent in 2 years, 80 percent in 15 years, and the remainder 2 percent in 25 years). It covers 100 percent of EU tariff lines and 74 percent of EAC tariff lines. EAC’s excluded products include agricultural products, wines and spirits, chemicals, plastics, wood-based paper, textiles and clothing, footwear, and glassware. The Agreement also allows “single transformation” for clothing to be eligible for duty-free, quota-free entry into the EU market (the same rules of origin as AGOA) and covers the fisheries sector, mainly aiming at reinforcing cooperation on sustainable use of resources and improving rules of origin for fisheries products.
Kenya's industries are to meet the evolving challenges associated with competing in developed markets. Three broad priorities are raising awareness about good agricultural practices; improving pest risk assessment and management capacities; and improving landing sites and environmental management in Lake Victoria.

3.35 In other sectors, quality, standards, and conformity-assessment systems should follow a medium-term strategy of diversification into new regional and global export markets. With this goal in mind, it is important that institutions for setting standards and assessing conformity are reoriented toward facilitation. This will necessitate increased private-sector participation in the regulatory debate and private-sector provision of services (mainly testing, conformity assessment, and consultancy), whenever possible. Regionally, the government should lead efforts to develop joint sanitary and phytosanitary management capacity and share selected resources. The use of Kenya's pending accreditation system as a regional platform is an obvious starting point. Other promising areas for regional cooperation are cross-border management of pests and diseases (a clear public international/regional good); food safety, hygiene services and training in the tourism industry; and establishing "regional centers of excellence" in instances where capacity is lacking in neighboring countries and regional markets.

3.36 The World Bank (2007a) report identified several shortcomings in Kenya's trade institutional framework. The main weakness is that policy making for trade is divided among various ministries and institutions without an effective coordination of policies. Under the current institutional structure, the Ministry of Planning and National Development (MPND) nominally takes the lead in formulating trade policy and the Ministry of Trade and Industry (MoTI) oversees implementation. In practice, these roles are not clear-cut, and as many as 12 ministries are involved directly and indirectly in developing and implementing trade policies and programs. There is a need for streamlining the responsibilities of various ministries and developing an effective coordination mechanism at the level of consultation with the stakeholders, policymaking, and implementation. It is equally important that the MoTI closely consult with exporters to remain informed about developments. To that end, the various public-private consultative bodies and committees on trade policy should be consolidated into one such body. Particular attention should be given to ensuring effective private sector participation in the consulting mechanisms.

Industry/Sector-specific Actions

3.37 As argued in the growth strategy section of Chapter 2, industry/sector-specific policy actions also have the potential to improve competitiveness, beyond the across the board measures discussed above. One issue in this regard is what sectors/industries should receive government attention because the government could end up spending public resources to support "strategic" sectors that turn out to be not so strategic after all. The Vision 2030 document identifies tourism, agriculture, retail and wholesale trade, manufacturing, business process outsourcing, and financial services as the potential "engines of growth" and develops sector strategies for each of them.59 These sectors mostly appear to be well chosen. Tourism's potential is widely accepted. There can be no doubt about the importance of agriculture and manufacturing sectors to the growth strategy. Finally, information and communication technology-based services could also have the potential since Kenya has a skilled and English-speaking labor force. However, the issue is more in terms of what is done within each of these main sectors. The following paragraphs attempt to address this issue.

59 National Industrial Policy, draft interim report, Ministry of Trade and Industry (GoK 2007c) also develops a list of government actions for various sectors.
3.38 A general caution based on experience of other countries is that tailoring government policy or tying up government resources and management capacity to the identified sectors could be costly: in terms of both opportunity costs and direct costs. Instead of developing and implementing grand sector strategies, it is better to focus first on generic economy-wide reforms. Sector interventions, where needed, would be more in terms of addressing government/market failures specific to a sector/industry. These sector/industry-specific actions would relate to competition, regulation, bottlenecks in supply chain, information gaps, infrastructure gaps, coordination failures, and so on. They would not entail tax breaks, subsidies, or direct financial support. Kenya’s own experience of past successes is illuminating in this regard. For example, in the horticulture industry, much of the success has been attributed to the “light” regulation and taxation by the Horticultural Crops Development Agency rather than government financial support. Similarly, tea exports have benefited from the supervision of the Kenya Tea Development Agency, which efficiently manages input provision and collection of green leaf tea, and from allowing smallholders to sell their produce directly to buyers, rather than any input subsidies (World Bank 2007a).

3.39 Within the main sectors identified by Vision 2030, there are possibilities of policy actions at the subsector/product level. For example, the National Export Strategy Implementation Action Plan 2005 (GoK 2005a) covered livestock and livestock products, fish and fish products, textiles and clothing, horticulture, and food and beverages subsectors. It came up with sensible actions that the government could take to accelerate export growth in the identified subsectors (Appendix F contains an excerpt from this action plan). A general approach in identifying subsectors/products for government support is to listen to the private sector. This means that the government follows the private sector rather than try to lead it. If this approach were followed, the first stop would be the sectors/industries that have already achieved a success, or where success is building. For example, the government would first concentrate on providing an enabling environment to recover, maintain, or improve its competitive position in traditional sectors, along with nontraditional, natural resource-based industries in which there is proven potential for growth and poverty reduction.

3.40 Using the approach described above, this report identifies policy actions to accelerate growth in ICT-based industry in Chapter 4. An ongoing study at the World Bank is attempting to identify actions for the tourism subsector (World Bank 2008b). Appendix G contains selected preliminary findings of the study.

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60 Similarly, the World Bank (2005) report includes recommendations for clothing, coffee, and pyrethrum sectors based on value-chain analysis.

61 Beyond the existing successes, or sectors/industries where success is building up, analysis can suggest other products to be “targeted.” For example, the PRODY methodology discussed earlier in this section can be used to generate a list of products where Kenya would have the potential to develop comparative advantage. However, a general caution should be used against such an exercise to be taken at its face value. The private sector would remain the best judge of what is possible, and the government would do well to follow the private sector rather than lead it.
4. IMPROVING TRANSPORT AND TELECOMMUNICATIONS SERVICES

4.1 Reducing the cost and improving the quality of transport and telecommunication services is expected to generate significant benefits to the Kenyan economy. The benefits would accrue through reduction of transaction costs and improvement in productivity. The benefits would reach the whole economy because all real productive activities use these services, but manufacturing and tourism sectors would benefit more than others would. In a background paper done for this report, Ballistreri, Rutherford, and Tarr (2008) estimate that Kenya could gain as much as 9.9 percent of consumption or 8.3 percent of GDP by reforming its business services. This chapter identifies a policy agenda for reforming transport and telecommunications services.

TRANSPORT LOGISTICS

4.2 Kenya's transport logistics include air, rail, maritime, road, and pipeline facilities. Performance and issues vary enormously across these sectors. Reforms have resulted in a well functioning air transportation system. However, Kenya's port, rail, and road transportation services are a significant drag on the competitiveness of its exportables. These problems were highlighted by Kenya's ranking on the international Logistics Perception Index of 2006. Of 150 countries, Kenya ranked seventy-fifth—below several African countries, although above the average for Sub-Saharan Africa.

Maritime Transport

4.3 Kenya's port operations are plagued by complicated bureaucratic procedures and inefficient handling of containers. The Kenya Ports Authority (KPA), a statutory body under the Ministry of Transport, operates the international port at Mombasa. Both port and container traffic at Mombasa port have increased substantially since 2002 and KPA is struggling to improve the efficiency of handling operations to meet the demands of increased traffic. It takes an average of two weeks to clear a container at the port; for 18 percent of containers, it takes as much as three weeks. Performance of the port suffers from lengthy clearance and documentation procedures. Although most of the procedures relate to customs documentation, other government agencies exacerbate the problems. In 2007, at least ten government agency stamps were required on clearance documents to clear a single container. Handling and management of containers within the terminal is still based on an ineffective manual card system.

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62 The paper covers banking, insurance, and wholesale and retail distribution services in addition to transport and telecommunications services. These gains are static gains: a one-time increase in the level of GDP.

63 This chapter does not get into the details of trade logistics issues at the borders (such as customs), which are equally important for competitiveness, as discussed in the previous chapter. World Bank (2007a) has detailed policy recommendations on that topic.

64 The Logistics Perception Index measures the perceptions of managerial level personnel of international freight forwarding companies. It is published by the Global Facilitation Partnership for Transportation and Trade and is available at www.gfptt.org.

As a result, shipping and clearing agents cannot rely on KPA systems to keep track of their containers. Efficient international container terminals moved to computer-based systems for the organization and management of container stacking and storage in the 1980s; Mombasa needs to do the same as a top priority.

4.4 The sluggish clearance and handling procedures result in delays and an increase in overall cost of trading goods, which has an adverse impact on Kenya’s competitiveness. It takes, on average, ten days to clear imports, compared with five days each in Senegal and India, and four days in China (Figure 4-1). Firms report that median cost of clearing customs is 6.2 percent of consignment value (ICA 2007). The cost of exporting a cargo container from Kenya is also relatively expensive. According to the “Doing Business” report, the cost to export a 20-foot container is US$1,955 in Kenya, compared with US$728 in Mauritius, US$390 in China, and US$1,155 in Mozambique (World Bank 2007e).

Figure 4-1: Days to Clear Imports and Exports (Median), Selected Manufacturing Firms, Cross-Country Comparison

Source. Compiled from World Bank Investment Climate Assessments, various countries and years.

4.5 Reforms are being implemented, however. KPA has set itself the goal of being in the top 20 in the world in terms of performance and reputation by 2010. The reform program includes transforming KPA into a landlord port authority, separating the commercial and regulatory functions, and putting commercial operations via concessions into the private sector.66 However, the Kenya Ports Authority Act has not been amended to allow for the envisioned private sector participation. Areas of progress nonetheless include privatizing conventional cargo operations; issuing concessions for operating dockyard facilities and inland container depots as a step toward privatization; corporatizing Mombasa Container Terminal and Marine Services, including pilotage, through listing on the stock exchange; and outsourcing Bandari College67 (Helu 2007).68 There are also on-going projects to improve automation, such as the Waterfront Project and the Community Based System, which will increase the flow of reliable information to stakeholders and reduce the reliance on a paper-based system. Achievement of full e-port status, however, will

66 The commercial functions at the port would be handled by the private sector, while the landlord port authority would handle safety and regulatory functions and some infrastructure and maintenance functions.

67 Bandari College of Maritime Studies was established in 1980 as a training and staff development institution of the KPA.

68 As of 2007, close to 50 percent of port operations had been privatized, including handling of bulk grains, soda ash, cement, fertilizer, empty containers, and motor vehicles.
require KPA collaboration with the Kenya Revenue Authority and other agencies operating in the port.

4.6 Completing the modernization reform program will require strong political will, as modernization reduces opportunities for rent seeking (automation of container tracking is a good example, which has been resisted) and needs to be pushed with stronger political resolve than has been visible in the past. It would be advisable to temper ambitious plans for modernizing the port, expanding the facilities, and developing new port services Box 4-1, and give priority to accelerating the ongoing reforms with political will and support from the highest level. Most importantly, the private sector—the ultimate beneficiary of reforms—should be actively involved in the execution, monitoring, and evaluation of the reform program.

Box 4-1: Extension of Port Services Envisioned by Kenya Ports Authority

Improvements at the port of Mombasa
KPA’s plans for improvements at the port of Mombasa include increasing handling capacity by increasing the number of container handling berths. KPA also plans to develop a second container terminal west of Kipevu Oil Terminal, at an estimated cost of KSh 22 billion. Complete financing for the project has been secured from the Japanese Bank for International Development. Construction on the first phase of the project is scheduled to begin in 2008 and completed around 2020.

Second seaport city
There is a proposal to construct a second commercial seaport to the north of Mombasa to serve not only Kenya, but also other countries such as Ethiopia, Somalia, southern Sudan, and Uganda. This would be done through a public-private partnership program.

Cruise ship reception facilities
The Mombasa port lacks cruise ship reception facilities, which, if available, would contribute to the development of cruise ship tourism. The KPA has solicited offers to develop and operate a Cruise Passenger Terminal facility through public-private partnership arrangements.

Development of a free port
KPA is contemplating a free port (free trade zone) in the port of Mombasa through a public-private partnership. Goods entering the free port would be considered outside the customs territory of Kenya and not subject to duty. The plan is to create a free port with a business-friendly environment and good infrastructure to encourage exporters. Existing laws, however, do not allow the development of such a facility and little private sector interest has been shown to date.

4.7 Some institutional reforms at KPA may also be warranted. Since 2000, KPA has received some limited flexibility, but still lacks sufficient flexibility to respond to market demand changes. It suffers from extensive intervention by the government in decision making and lack of clarity in its role vis-à-vis the government.\(^{69}\)

\(^{69}\) All major decisions of the KPA Board involve a lengthy decision-making process involving all responsible ministries of the government and the Office of the President; this includes privatization decisions. For example, the government has not approved the privatization of management and operation of the inland container depots and container terminal operations; and the government intervened in awarding the rights to do grain bulk handling. Although the KPA Board approved a plan to carry out staff rationalization and retrenchment, the government has not approved the plan. A considerable number of employees on temporary contracts were added in 2006.

48
Roads Infrastructure

4.8 Kenya's road network is in a state of disrepair. In 2003, fully one-third of the classified road network was in a poor or worse condition and required major maintenance or reconstruction to restore it to original functionality (Table 4-1). In comparison to other countries in Africa, this is a reasonably high proportion of the classified network in good/fair condition, but the condition of the road network is widely perceived as a binding constraint on accelerating growth.

<table>
<thead>
<tr>
<th>Condition</th>
<th>kms</th>
<th>Share of total classified (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good or Excellent</td>
<td>11,400</td>
<td>18</td>
</tr>
<tr>
<td>Fair</td>
<td>31,200</td>
<td>49</td>
</tr>
<tr>
<td>Poor</td>
<td>16,900</td>
<td>27</td>
</tr>
<tr>
<td>Very poor</td>
<td>3,800</td>
<td>6</td>
</tr>
<tr>
<td>Total</td>
<td>63,300</td>
<td>100</td>
</tr>
</tbody>
</table>


4.9 In the medium to long run, a sizable volume of funds would be required to rehabilitate and maintain the network. The government estimates that backlog maintenance would require approximately K Sh 150 billion, which if implemented over a seven-year period would equate to K Sh 21.4 billion per year. Periodic and routine maintenance would require an additional K Sh 15 billion per year, increasing over time in proportion to the size of the rehabilitated and maintainable road network (GoK 2006).

4.10 To generate additional public resources for rehabilitation and maintenance, the government increased the road maintenance levy in June 2006. The government has also been allocating increasing budget amounts for development projects (executed by the Ministry of Roads). There may be a possibility of attracting donor funds for rehabilitation of the network, provided the government can credibly commit to a list of rehabilitation projects that have been prioritized based on economic analysis.

4.11 The government’s strategy is that backlog rehabilitation shall have priority over new developments. However, equal importance needs to be attached to the routine and periodic maintenance of roads in good/fair condition. If investments are focused only on rehabilitating the roads in poor condition, the roads in good/fair condition will quickly deteriorate to poor condition, requiring expensive rehabilitation works in future. It is estimated that for every shilling deferred in maintenance, society stands to lose 3 to 6 shillings in higher vehicle operating and future rehabilitation costs.

4.12 There are serious issues about the efficiency of use of existing resources made available to the Roads Department. A review of the roads sector portfolio conducted by the Bank jointly with the Roads Department in 2006/7 identified several problems in project planning,

70 The Road Maintenance Fuel Levy generates about KSh 10–12 billion every year, which is considered sufficient for routine and periodic maintenance of the existing classified road network once it is rehabilitated to maintenance standards.

71 A prioritized list of 72 road works requiring rehabilitation, widening, and upgrading has been developed by the Ministry of Roads with the support of the World Bank.

72 Background paper “Kenya: Rehabilitating and Maintaining Road Network for Growth.”
preparation, and implementation, resulting in low budget utilization and inefficient use of resources in the form of cost and time overruns. Chapter 5 returns to the issue of efficiency of public expenditure on roads in details.

4.13 Inadequate financing and prioritization are not the only issues. The institutional framework in the Ministry of Roads is unsuitable and too cumbersome for efficient and effective delivery of road works. Through the Roads Bill of 2007, the government has created three statutory road authorities: the Kenya National Highways Authority, to be responsible for the development and management of major roads (Class A, B, C); the Kenya Rural Roads Authority, to be responsible for development and management of rural and small town roads (Class D, E and others); and the Kenya Urban Roads Authority, to be responsible for development and management of roads in the cities and municipalities. Expeditious transition to the new institutional set-up would help improve implementation of roads works.

4.14 There is also a need to improve capacity in the local construction industry. The government’s role could be in terms of strengthening professional governance and self-regulation. For example, the government could strengthen the Engineers’ Registration Board and further empower it to discipline and sanction engineers and firms that perform poorly and violate its charter with regard to professional conduct and ethics. The same is true for the Association of Consulting Engineers. The government could also assist the construction industry in establishing a professional body for construction contractors (Association of Buildings and Roads Construction Contractors) and strengthen it to engage in self-regulation. Lastly, the government could strengthen the contractors’ registration process to ensure regular updating of contractors’ qualifications and capacity, facilitate training in different aspects of construction and supervision techniques, and to reprimand poor performance.

Reducing Transportation Costs through Administrative Measures

4.15 It is important to note that reducing transport costs does not necessarily mean developing new roads and highways, or even expanding the capacity of existing roads and highways.73 An ongoing study (World Bank 20070) on transport costs and prices in Africa has recently compiled data on transport costs in Africa along four international transport corridors.74 Table 4-2 shows that variable costs faced by trucking companies at $0.98/km are the lowest for the Northern Corridor, while their fixed costs are relatively higher. In terms of transport prices (Table 4-3), which are the cost to final consumers of transport services, however, the Northern Corridor is at the higher end. This shows that variable costs, which reflect the vehicle operating costs (which, in turn, depend upon the condition of the road) are less important component of final price faced by the consumers.

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73 As discussed later, each of these new infrastructure projects should be submitted to rigorous cost-benefit analysis. While developing new transport infrastructure need not be a top priority, rehabilitating and maintaining the existing infrastructure would have high rates of return.

Table 4-2: Averaging Operating Costs in Selected national Corridors in Africa

<table>
<thead>
<tr>
<th>Corridor</th>
<th>Route gateway-destination</th>
<th>Variable cost (VC) (US$/km)</th>
<th>Fixed cost (FC) (US$/day)</th>
<th>Yearly ratio FC/VC (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Africa</td>
<td>Douala–Yaoundé (Cameroon)</td>
<td>1.15</td>
<td>52</td>
<td>28–71</td>
</tr>
<tr>
<td></td>
<td>Douala–Bafoussam</td>
<td>0.98</td>
<td>46</td>
<td>28–71</td>
</tr>
<tr>
<td>East Africa</td>
<td>Mombasa–Nairobi (Kenya)</td>
<td>0.83</td>
<td>63</td>
<td>54–45</td>
</tr>
<tr>
<td></td>
<td>Mombasa–Eldoret</td>
<td>0.98</td>
<td>62</td>
<td>56–43</td>
</tr>
<tr>
<td>West Africa</td>
<td>Tema–Accra/Kumasi (Ghana)</td>
<td>1.52</td>
<td>30</td>
<td>15–84</td>
</tr>
<tr>
<td></td>
<td>Tema–Accra/Tamale</td>
<td>1.61</td>
<td>26</td>
<td>10–89</td>
</tr>
</tbody>
</table>

Source: World Bank (2007 f, Table 3.3).

Table 4-3: Transport Prices in Africa

<table>
<thead>
<tr>
<th>Corridor</th>
<th>Average transport price per ton-km (U.S. cents)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Southern Africa corridor (North–South)</td>
<td>4–5</td>
</tr>
<tr>
<td>West Africa corridor (Cotonou–Niamey)</td>
<td>6–8</td>
</tr>
<tr>
<td>East Africa corridor (Mombasa–Kampala)</td>
<td>8</td>
</tr>
<tr>
<td>Central Africa corridor (Douala–Chad)</td>
<td>10–25</td>
</tr>
</tbody>
</table>

Source: World Bank (2007 f, Table 3.1).

4.16 The study reaches a few important conclusions:

- A major cause of high transport prices is lower than optimum truck usage—due mostly to factors not related to infrastructure.

- As long as international corridors are paved in a fair condition, road capacity does not emerge as a major hindrance to transport efficiency. The existing physical infrastructure may not be considered to be the most binding constraint on several international corridors in Africa including the Northern Corridor.

4.17 The study identifies idling time—the opportunity cost of waiting while loading, unloading, and completing administrative procedures at the borders and ports—to be much more important determinant of transport prices than variable costs, which are determined by the physical condition of road infrastructure. The lesson from this study is that from a trade logistics point of view, reducing wait time at the port, weighbridges, and borders is at least as important as expanding the capacity of existing roads. As for roads, giving priority to certain sections—for example, those that are acting as a bottleneck to off-take from the port—would bring higher benefits.

Implementing and Monitoring Logistics Reforms as a Package

4.18 As recommended by the World Bank (2007a) report, logistics reforms should be implemented and monitored as a package, since the weakest link in the supply chain can act as a bottleneck for the entire chain. A set of logistics indicators should be developed to benchmark reforms and progress. The weakest link in the chain should get attention first. It would be critical that the private sector occupy an important role in driving forward reform, as well as in some advisory capacity.
TELECOMMUNICATIONS

4.19 Telecommunication services are an important source of productivity improvement in supply chain management. They are also critical to the ICT-based service industry that is seen as having potential to drive the growth targets in Vision 2030. Considerable success in liberalizing the sector has already been achieved which is acknowledged by the private sector. In ICA 2003, telecommunication services were cited as one of the major constraints faced by the private sector; in the 2007 ICA, they were no longer cited as a major obstacle for doing business. The ongoing liberalization has already resulted in a significant decline in costs, yet more can be done. A regional and international comparison shows that telecommunications services remain relatively costly and there is further scope to improve competition in the sector to bring down costs further.

4.20 The government has implemented significant reforms in the sector in the last ten years. The fixed-line incumbent Telkom Kenya Limited (TKL) was partially privatized in 2007; following a sale of 51 percent of shares, it is now jointly owned by the government and France Telecom. In 2004, TKL’s exclusivities were terminated and the licensing process for a second national operator (SNO) initiated. Competition in the mobile market was also introduced in 2000, when a second mobile license was issued to Celtel. The first, Safaricom Limited is jointly owned by TKL (60 percent) and Vodafone Kenya, which acquired a 40 percent share of Safaricom in 2000. An Initial Public Offer (IPO) of 25 percent of Safaricom shares to the residents of East Africa was undertaken by the government in 2008 to broaden ownership further. A third mobile license was issued in 2003 to Econet Wireless Kenya who have yet to start operations but are anticipated to do so in 2008. Since 2004, additional competition to provide telecommunications services has been generated by the licensing of four Internet backbone suppliers, seven public data operators, and five commercial Very Small Aperture Terminal (VSAT) operators. Voice over Internet Protocol (VoIP) was legalized in 2005, and mobile operators were granted licenses for international voice services the following year.

4.21 Despite the reforms, there is a relatively high cost of services and some performance indicators do not compare well in the region. The high direct dial rates of fixed line outgoing international calls may in part be attributed to the current monopoly position of TKL; and the relatively high costs of mobile telephone services is likely to be due to the duopolistic market structure. It is important, therefore, that additional operators appear on the market; and the prospect of the third mobile operator commencing operations is a welcome addition to improve competitiveness in the industry.

4.22 In the fixed line market, TKL does not have any legal exclusivity, yet its market share remains at 99 percent, and there is very limited competition. This has at least three effects: prices remain high, access is low, and service delivery is poor. Using a comparison of the monthly basket of connection, subscription, and on- and off-peak calls, Kenya’s fixed line basket was

75 The government’s initial strategy for the sector was outlined in the Postal and Telecommunications Policy Statement of 1997. The strategy outlined a more liberal and private sector-led development designed to optimize the sector’s contribution to the economic growth of Kenya. The Policy Statement led to the enactment of the Kenya Communications Act of 1998, which created the Communication Commission of Kenya (CCK) as an independent regulator of the sector. Since the passage of the Act, Kenya has been gradually liberalizing the telecommunications sector. The Information and Communications Technology Sector Policy Guidelines of March 2006 further confirm the more liberal, private sector-led strategy.

76 Legalizing VoIP really put Kenya ahead of the game. Currently, 36 African countries still prohibit VoIP adoption except by the monopoly incumbents. Only seven countries have legalized VoIP services (Algeria, Kenya, Mauritius, Somalia, South Africa, Tanzania, and Uganda).
twice as expensive as Rwanda and was the highest of the countries surveyed in a recent World Bank Study (Table 4-4).77

Table 4-4: Telecom Monthly Basket Price Comparison, Selected SSA Countries, 2006 (US$)

<table>
<thead>
<tr>
<th></th>
<th>Fixed line</th>
<th>Prepaid mobile</th>
<th>Dial-up Internet</th>
<th>International Internet bandwidth bits per person</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ethiopia</td>
<td>1.65</td>
<td>4.03</td>
<td>14.72</td>
<td>0.32</td>
</tr>
<tr>
<td>Sudan</td>
<td>5.01</td>
<td>4.54</td>
<td>29.57</td>
<td>6.78</td>
</tr>
<tr>
<td>Rwanda</td>
<td>7.65</td>
<td>9.46</td>
<td>84.13</td>
<td>2.33</td>
</tr>
<tr>
<td>Tanzania</td>
<td>10.48</td>
<td>9.19</td>
<td>144.39</td>
<td>2.67</td>
</tr>
<tr>
<td>Uganda</td>
<td>12.30</td>
<td>9.46</td>
<td>94.40</td>
<td>4.93</td>
</tr>
<tr>
<td>Kenya</td>
<td>14.16</td>
<td>15.86</td>
<td>81.13</td>
<td>5.12</td>
</tr>
</tbody>
</table>

Source: TMG (2007).
Note: The fixed line basket is calculated using a post-paid basket comprised of one-fifth of the connection fee, the monthly subscription and fifteen three-minute peak and fifteen three-minute off-peak calls. The prepaid mobile basket is based on OECD methodology (see TMG 2007). The dial-up Internet basket is based on ten hours of off-peak and ten hours of peak use per month. This does not necessarily compare like with like, since the speed of connection is also likely to vary by available bandwidth. Unfortunately, data for broadband services were not available. Mobile and Internet prices include taxes.

4.23 Key performance indicators for the fixed line market show that Kenyans suffer long waits for a connection and unreliable service. Firms reported waiting over three months for a main line connection—more than one-and-half times the average in Africa. In 2006, only 60 percent of the half a million lines were actually connected and in service. Outages, incomplete calls, and faults per line are all considerably higher in Kenya than many of its neighbors (Table 4-5). Kenya’s main fault line rate is three times higher than the Sub-Saharan African average.

Table 4-5: Quality of Fixed Line Service Indicators, Selected SSA Countries, 2005

<table>
<thead>
<tr>
<th></th>
<th>Percent of faults cleared by next working day</th>
<th>Percent of unsuccessful calls—local network</th>
<th>Number of faults per 100 main lines per year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tanzania</td>
<td>87</td>
<td>--</td>
<td>47</td>
</tr>
<tr>
<td>Sudan</td>
<td>90</td>
<td>--</td>
<td>96</td>
</tr>
<tr>
<td>Uganda</td>
<td>93</td>
<td>2.8</td>
<td>--</td>
</tr>
<tr>
<td>Kenya</td>
<td>43</td>
<td>21</td>
<td>145</td>
</tr>
</tbody>
</table>

Source: TMG (2007).
-- not available.
a. Data for Tanzania are for 2004.

4.24 Given the poor performance, a second national operator (SNO) and the privatization of TKL offer considerable opportunities for service improvements (Box 4-2). The plans to issue a SNO license have stalled. Although the government has issued 19 “local loop provider” licenses, operations are restricted in scope and geography and interconnection is difficult; hence, only a handful of the entities holding licenses have actually launched services.

77 TMG (2007). Competition from mobile and VoIP keeps the cost of international calls down. As a result, the price of international calls is relatively low, the lowest being VoIP from Telkom Kenya, which charges only US$0.21 per minute for calls to the United States.
Box 4-2: Realizing the Potential from Strategic Investors and Competition

Kenya has been one of the more liberal reformers in the area of telecommunications. There is no reason to stop now, and much can be learned from other reform success stories in the region. Morocco licensed a second mobile operator and sold 35 percent of the incumbent in 1999. Mobile quickly surpassed fixed line provision. However, the fixed line provider responded to the competition and two years later, there were 3 million fixed line customers. The dynamism continued into Internet provision, and broadband now accounts for 98 percent of all Internet connections, with speeds as high as 214 Mbps (used by 6 percent of users in 2006). Nigeria issued three mobile cellular licenses in 2001 and a SNO in 2002, and more than a dozen local network licenses have been granted since 2000. Population coverage of mobile networks increased from 5 percent to 75 percent between 2000 and 2006. Nigeria now has some of the most competitive fixed and mobile markets in Africa and Celtel has deals that offer prepaid customers 60 to 120 minutes of free on-network weekend calls.

4.25 The mobile sector has been more successful in expanding access and providing quality service. Competition from Code Division Multiple Access (CDMA)-based services, which offer some of the cheapest tariffs in the market, has helped in reducing tariffs.78 The sector has also been innovative in offering new services (such as the M-PESA79, the mobile phone money transfer service offered by Safaricom). However, the monthly basket of mobile tariffs is still relatively high—largely driven by much higher peak call tariffs—at almost $16 per month, compared to the SSA average of $12 per month.

4.26 The price of mobile phones and calls could be brought down further. The issue of additional licenses could improve competition and put further downward pressure on prices. So far, the third mobile license operator has not materialized, although it seems likely that a new mobile operator (70 percent owned by Econet) has managed to finance the fee requirements and is due to start operations. The high prices are also driven by relatively high interconnection rates and are not helped by the addition of a 10 percent excise tax (Table 4-4).80 The cost of owning a mobile phone could also be brought down, for example, by introducing ultra low cost handsets at around $10 each.81

4.27 Bringing the price of mobile phones and calls down would help extend coverage and boost Kenya's competitiveness. The potential productivity gains from increased mobile use are considerable. TradeNet, a software company in Ghana, has introduced a simplified version of e-Bay over mobile phones for agricultural products across more than 10 countries in West Africa. Such initiatives can improve the flow of business information, help reduce costs, and raise profits.

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78 Otherwise known as fixed-line wireless, currently TKL offers CDMA2000 1X nationwide. Two private operators, Flashcom Limited and E. M. Communications Ltd, provide services in Nairobi. In 2007, Celtel introduced a uniform tariff for calls to all networks and Safaricom followed with a new set of tariffs. This offered consumers huge concessions on airtime costs, bringing the average call costs to K Sh14 per minute and K Sh20 per minute for intra-network and across network calls, respectively.

79 The M-PESA service was originally created as a pilot funded jointly by Vodafone and the UK Department for International Development [DFID] Financial Deepening Challenge Fund. The pilot ran for over 6 months in Kenya from October 2005 in partnership with Faulu Kenya, a local Microfinance Institution.

80 This is unique to the region. It is quite likely that abolishing the excise tax would not only remove a distortion but also potentially raise revenues from greater mobile penetration. See TMG (2007).

81 Cheap handsets are already available in Chinese and South Asian markets. Bringing down the cost of mobile and extending coverage also reduces the need for universal service obligations.
4.28 The Internet market has many players, but accessing international Internet bandwidth is via expensive satellite technology rather than a fiber optic cable. The cost differential between undersea fiber optic cable and satellite is considerable, resulting in high prices. Even for dial-up services the cost of the monthly basket in Kenya is $81, compared to only US$30 in Sudan and US$15 in Ethiopia (Table 4-4). At least ten African countries now offer broadband below US$15 per 100 kbit/s per month—which is something for Kenya to aspire to. The lack of affordable international backbone bandwidth is probably the biggest obstacle to the development of the ICT industry and a major constraint to improving productivity across the economy. Several initiatives are underway to connect to the under-sea global fiber optic cable. The TEAMS initiative is well advanced with a contract signed in 2007 with Alcatel-Lucent to manufacture the cable to connect Mombasa with Fujairah, U.A.E. by end 2009. EASSy (which is a regional consortium with IFC backing) is an alternative to connect the east coast of Africa to the fiber optic cable also with a 2009 target implementation date.

4.29 The limited fixed line network constrains access to alternative ADSL Internet provision. The limited number of main lines, shortage of international connectivity, and inadequate inter-modal competition affects broadband development.

4.30 Universal service in Kenya is defined as the provision of communication services to rural and other high costs areas. During the monopoly era, this was the responsibility of Kenya Posts and Telecommunications, which installed public payphones in various parts of the country. Relative to countries with comparable income, Kenya has fewer fixed lines per capita. Kenya's fixed line tele-density is 0.84 percent; that is, Kenya has less than one fixed line telephone per one hundred inhabitants. TKL had a waiting list for fixed line phones of 85,177 customers in 2005, which has reportedly declined significantly since the wider use of mobile telephones.

4.31 In the liberalized market, mobile operators are called upon to provide coverage. With the growth in the mobile industry, the fixed telephone line density has fallen since it reached the 1:100,000 mark in 2002 to 0.9:100,000 in 2006. This is far below the Sub-Saharan African average of 1.7, and even Sudan's average of 1.91 per 100,000. If cellular subscribers are included, Kenya's tele-density increases to 19.6 percent by 2006, which is about 1.5 times the Sub-Saharan African average. These data indicate that the vast majority of Kenyans who receive telephone service obtain that service through mobile telephones. In practice, mobile operators exceeded the rollout obligations stipulated in their license agreements, and have been providing community payphones. However, estimates are that there is mobile telephone coverage for only about 60 percent of the country.

4.32 The government expects the private sector to play a key role in meeting universal service targets. In addition, it is establishing a Universal Service Fund to subsidize the cost of infrastructure to unserved areas. The Fund is to be financed by the operators, but the contribution of operators awaits enactment of the Information and Communications Technology (ICT) law.

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82 There is a reasonable degree of competition for service provision. There are some 39 Internet Service Providers (ISPs) in operation (although they are not all operating in all districts—most operate in only 8 out of 47); 8 International Backbone Gateway Operators; and 2 VSAT operators.

83 The cost of international broadband capacity is in the range of US$7000 per month for 1 Mbit/s duplex, compared to about US$700 in India or the Philippines. A leased circuit between Africa and Europe is estimated to cost US$130,000 per month for satellite, compared to US$25,000 for a submarine cable.

84 As of August 2006, those ten countries were Botswana, Cote d'Ivoire, Egypt, Madagascar, Mauritius, Morocco, Senegal, Sierra Leone, South Africa, and Tunisia (World Economic Forum 2007).
The ICT-enabled Services (ICTES) Industry

4.33 While there are some first movers into the call center market in Kenya, the sector is still relatively small. Reliable, affordable, high-speed Internet access is essential for the development of the business processing outsourcing (BPO) and other ICTES industry. It is therefore essential that one of the four possible projects to connect Kenya to the rest of the world with a submarine fiber optic cable be implemented as soon as possible. In the meantime, a World Bank project will provide subsidies to BPO operators to bring costs down to where they can be expected to be once the cable is in place.

4.34 The lack of international backbone is not the only obstacle to the ICT industry development. The expensive and unreliable or unavailable electricity is a major barrier. General business climate concerns such as security and corruption also need to be tackled. There is also considerable scope for deregulation to improve the ICT business climate. There are 50 types of service categories and associated licenses. A company must first identify the type of license that it needs to operate and potentially apply for all those that might apply—all of which are subject to numerous application fees and annual regulatory fee requirements. While the Communication Commission of Kenya (CCK) has plans to simplify the regime, it has not yet adopted them.

4.35 Another barrier to entry is the foreign ownership restrictions, which provide an additional disincentive to foreign investment. The Government of Kenya currently requires that telephone companies must be at least 30 percent owned by Kenyan nationals. The 30 percent ownership requirement is delaying licensing of additional telecom operators. In this context, the plan of the government to allow the SNO to operate for at least one year without meeting the 30 percent local ownership requirement is a useful first step. If a viable Kenyan partner cannot be found, however, the government would be wise to consider abolishing the 30 percent local equity requirement.

4.36 There may be some benefits from tying proposed reforms in the telecom sector to World Trade Organization (WTO) commitments in ICT. This will give some policy credibility, which is badly needed given the number of currently stalled initiatives to improve competition, reduce the public sector ownership, and deregulate the industry. African countries that have made commitments had higher growth in sector revenues than countries that have not, Bressie, Kende, and Williams (2005) found.

4.37 With a view to strengthening the development of its ICT sector, Kenya should also join the optional WTO Information Technology Agreement (ITA). This would bind Kenya to eliminate customs duties on major information technology products (Box 4-3). Joining would thus reduce the cost of ICT inputs, and encourage new investment in Kenya and broaden access to IT inputs to include smaller businesses. Given that imports of many IT products are already subject to exemptions, the impact on revenues is unlikely to be significant. Moreover, joining the ITA would allow the exemption scheme to be dismantled, and thus save on administrative costs.

85 Information Week estimates it at US$5 million, with 3,000 employees. See www.informationweek.com

86 World Bank (2007i). In addition to government and higher education institutions, the World Bank Regional Communications Infrastructure Program (RCIP) has US$8 million to provide targeted subsidies to the BPO industry to bring international broadband costs down where they might be expected to be in the longer run (approximately US$1,000 Mbit/s per month). The subsidy will be consistent with World Trade Organization obligations and will be transitional and nondiscriminatory, based on a fixed amount and a fixed time-period.
Box 4-3: The WTO Information Technology Agreement

The Information Technology Agreement (ITA) is a tariff-cutting mechanism with three basic principles. All products listed in the Declaration must be covered. All must be reduced to a zero-tariff level. All other duties and charges must be bound at zero.

There are no exceptions to product coverage. However, for sensitive items, it is possible to have an extended implementation period. Commitments undertaken under the ITA are on a Most Favored Nation (MFN) basis, and therefore market access is extended equally to all WTO members. The agreement covers the main categories of IT products: computers, telecommunications equipment, semiconductors, semiconductor manufacturing equipment, software, and scientific instruments. ITA has 63 members, among them such developing countries as China, Egypt, El Salvador, India, Mauritius, Moldova, and Morocco. There are no least developed country (LDC) members.


Summary of Recommendations for Telecommunications

- Issue a SNO license.
- Issue a third mobile license.
- Streamline licensing, as per CCK plans.
- Get fiber optic international Internet access.
- Remove the 10 percent excise duty on airtime.
- Remove the foreign ownership requirement.
- Consider joining the optional WTO ITA.
5. FISCAL POLICY FOR GROWTH

5.1 Chapter 2 argued that Kenya’s fiscal policy has a major role to play in pursuit of growth. The policy challenge before the Kenyan authorities is how to scale up spending rapidly in order to maintain and rehabilitate infrastructure while maintaining macroeconomic stability. The challenge needs to be seen in conjunction with the competing demand for social spending, which has been increasing at a fast pace following the government’s adoption of free primary education in 2003 and various health goals. In other words, the goal of fiscal policy in the medium term would be to create fiscal space for infrastructure and social spending (to accelerate attainment of the Millennium Development Goals) without compromising the solvency of public finances.

5.2 The discussion that follows argues that (limited) fiscal space for infrastructure spending exists, given the solid revenue mobilization, good debt dynamics, and identified projects with high economic returns. At the same time, the government will need to squeeze more value out of its current level of social and infrastructure expenditure and curtail general administrative expenditure. This chapter covers the education, health, and roads sectors from the point of view of stretching the shilling. The coverage of public expenditure policy in these sectors is selective rather than comprehensive, focusing only on areas where there is scope for improving efficiency.

REVENUE MOBILIZATION

5.3 The quality of a nation’s fiscal stance and its conduciveness to long-run growth and poverty alleviation depend upon the efficiency and adequacy of revenue mobilization and expenditure composition. In spite of the decline in revenues since the mid-1990s, the revenue-to-GDP ratio at around 21 percent is high in Kenya compared to other countries of a similar income level. Kenya—which collects about 7 percentage points of GDP more in revenue than its East African Community partner Uganda, and about 4 percentage points more than Tanzania—is a positive outlier among developing countries.

5.4 The structure of revenue in Kenya is conducive to growth. An important consideration in tax policy is that the taxes should minimize relative price distortions and should be predictable. In this regard, Kenya has undertaken several impressive reforms in tax policy since the mid-1990s. These include reduction in import tariffs, reductions in income taxes, reduction in value added tax (VAT) rates, and extension of VAT coverage. Figure 5-1 plots four important revenue components over the 1995/96–2006/07 period: import and excise duties, income tax, and VAT as a percentage of GDP. The figure illustrates the point that revenue initially fell as tax rates were cut, but has picked up after 2002 because of stronger tax administration. The steady decline in import duty collection is due to trade liberalization policy. Income tax displays a U-shaped pattern, falling in the late 1990s, but then, unlike import duty, recovering after 2003. This is encouraging to the extent that it captures lower tax rates combined with a broadening of the tax base and improving compliance, which is the case in Kenya. Cutting income tax rates would have increased the incentives for investment by raising private returns to capital. In combination with the increased competition from imports, this would have spurred both new investment and higher productivity in firms, improving growth prospects. The same factors are likely to increase private sector confidence. VAT was introduced in 1990; the number of rates has been reduced from 15 (with the highest rate once 210 percent) to a unified rate of 16 percent (except for some zero-rated products), with obvious advantages of reducing misclassification and tax evasion and easing
administration. Excise duties have been largely replaced by the VAT, except on oil imports and other specific products.

**Figure 5-1: Revenue Mobilization (% of GDP)**

5.5 Several impressive reforms have also taken place in tax administration. These include setting up a large taxpayers unit and other reforms in the Kenya Revenue Authority (KRA) as part of a revenue administration reform and modernization program. However, these reforms are not yet complete.

5.6 An important conclusion from the discussion above is that Kenya has managed a successful transition from a high tax rate, low tax base system with considerable reliance on import taxes and seigniorage (Box 5-1) to a more efficient and equitable revenue system based on broad-based taxes like income tax and VAT. This accomplishment is considered difficult to achieve. Countries marked by political instability, social division, and weak governance—which is the stereotypical image of Kenya—are more likely to rely on seigniorage and import tariffs: taxes that are relatively easy to collect but highly distortionary.

5.7 The above accomplishment, however, must be seen against the background that businesses perceive tax administration to be burdensome and tax rates to be high. As discussed in Chapter 3, further analytical work is needed to see if at the margin tax rates are a deterrent to investment and if average tax burden is excessive. Pending such work, any increase in tax rates with an objective to finance increased spending on infrastructure should be cautiously considered. At the same time, there may be limited scope for further increase in revenues by expanding the tax base and improving revenue administration. Another approach to counter the negative perception of businesses about taxation would be to ensure higher efficiency in government spending. Businesses are less likely to resent taxation when they can see the benefit of taxes accruing in the form of efficient public services.
Box 5-1: Reliance on Seigniorage as a Source of Revenue

Figure 5-2 plots both the growth rate of reserve (base) money and the change in reserve money divided by GDP (an indicator of seigniorage). Both the level and volatility of these indicators have declined sharply after 1999. This in turn could have contributed to lower macroeconomic uncertainty and inflation, lowering interest rates. In this context, the rise in the growth rate of reserve money in 2006 and 2007 needs to be viewed with some concern, particularly in view of double-digit headline inflation rates in these years.

Figure 5-2: Growth and Change in Reserve Money, Kenya, 1981–2006

Source: Data from the Central Bank of Kenya.

EXPENDITURE POLICY

5.8 The major complaint voiced by the private sector pertains to the quantity and quality of infrastructure. Roads in particular are singled out. The fuel levy has not translated into better roads. This brings us to the Achilles' heel of the Kenyan public finances: the expenditure policy. Figure 5-3 plots total primary expenditure and two of its key components: development expenditure and recurrent expenditure in the past ten years. The development expenditure consists largely of capital expenditure, and most of it is on public infrastructure. During the fiscal consolidation of the 1990s, the development expenditure was sharply cut from a high of 6.4 percent of GDP in 1994/95 to 1.9 percent in 1999/2000. The sharp cuts were accompanied by deterioration in the quality of public investment portfolio. A number of construction projects with questionable economic rationale were taken up (Eldoret airport was a prime example) and a large stock of incomplete projects accumulated.\(^{67}\) Maintenance also suffered severely and networks (roads and electricity) deteriorated. One estimate for roads puts the current backlog maintenance

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cost alone at approximately K Sh 150 billion; periodic and routine maintenance would require an additional 15 billion K Sh per year (about 0.7 percent of GDP).  

Figure 5-3: Primary Expenditure and Components

Source: Based on information provided by Kenyan authorities.

Fiscal Space for High-return Projects

5.9 Kenya does not appear to have a debt sustainability problem, and therefore has more latitude in generating fiscal space for infrastructure spending. Its debt dynamics have been especially favorable since 2003, as discussed. With Kenya's indebtedness on a steady decline over the past 10 years, the key question that policymakers need to ask is whether this trend should be preserved or whether an alternative goal may be socially more desirable, such as either keeping the government debt-to-GDP ratio constant or even letting it rise in the short run while alleviating the infrastructure constraint.

5.10 A debt-sustainability analysis carried out jointly by the World Bank and IMF in 2007 (IMF 2007) analyzed the impact of higher nonconcessional borrowing equivalent to 1 percent of GDP per year during the 2006–10 period to help finance additional public spending on infrastructure. The analysis pointed to considerable risks to public debt sustainability from higher nonconcessional borrowing if interest rates go up and there is no growth impact. Further analysis carried out for this report showed that risks are considerably mitigated if the borrowing results in improved growth performance. The policy lesson from the analysis is that largely untapped concessional resources should preferably be used effectively to meet infrastructure needs and any attempt to exploit the limited scope for additional borrowing for infrastructure needs should be explicitly linked to projects with unquestionably high rates of return.


89 The scenario also assumes that these amounts are raised domestically and result in an increase in domestic interest rates of 200 basis points throughout the projection period. During the projection period, the average real interest rate of domestic debt of 7.6 percent would still be substantially below the historical average of 10.2 percent. The analysis is carried out for additional commercial domestic borrowing, but equally applies to increasing nonconcessional external borrowing. Alternatively, it illustrates the risk to public debt sustainability when contingent liabilities result in additional non-concessional debt. This scenario further assumes that on balance additional borrowing has no effect on real GDP growth.
5.11 Institutional mechanisms for selecting high-return projects, however, are weak. Currently there does not appear to be a systematic process for identifying capital projects based on economic analysis. The Ministry of Finance (MoF) delegates expenditure prioritization within an overall ceiling to line ministries (including the Roads Board for maintenance of roads), but line ministries look back to the MoF for the final decision as to which projects are budgeted. There is ambiguity about the respective roles of the MoF and line ministries on individual project selection. There is a need to put in place an institutional mechanism (which could play the role played by the Public Investment Program earlier) for developing a pipeline of high-return projects. The MoF should also issue standard project identification and appraisal guidelines, supplemented with sector-specific guidelines for demand and benefit measurement.

**CREATING FISCAL SPACE BY IMPROVING THE QUALITY OF EXPENDITURE**

5.12 “Fiscal space” can also be “created” by more efficient public spending. Kenyan policymakers have long been sensitive to the need to improve value for money. The current government has focused attention on results, which aims to improve outputs for the given level of inputs. The prime candidate sectors for attention to efficiency are education, health, and roads. These sectors together accounted for more than half of total government expenditure in 2006/7. These sectors are also likely to be the source of fiscal pressures in the medium term, given the projected trajectories of their expenditure. The discussion that follows examines the scope for improving the quality of public expenditure in these sectors.

**Education**

5.13 The overall education budget of the government was 6.6 percent of GDP in 2005/6 and is above most Sub-Saharan African countries. In per capita terms, government’s basic education spending has been growing and was K Sh 4,750 per child (aged 6 to 17) in 2005/6. The fiscal challenge in education is to finance the ongoing expansion of school education on a sustainable basis and maintain or improve quality of education outcomes (Table 5-1).

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Actual K Sh billions</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total public sector</td>
<td>63.0</td>
<td>72.0</td>
<td>80.1</td>
<td>92.7</td>
<td>103.4</td>
<td>115.8</td>
<td>118.5</td>
<td>129.6</td>
</tr>
<tr>
<td>Government expenditure</td>
<td>60.9</td>
<td>68.2</td>
<td>77.2</td>
<td>86.3</td>
<td>94.8</td>
<td>106.4</td>
<td>110.9</td>
<td>120.8</td>
</tr>
<tr>
<td>Recurrent</td>
<td>2.6</td>
<td>4.1</td>
<td>2.9</td>
<td>6.5</td>
<td>8.6</td>
<td>9.4</td>
<td>7.6</td>
<td>8.8</td>
</tr>
<tr>
<td>Development</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>External assistance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government spend per child</td>
<td>2.96</td>
<td>4.17</td>
<td>4.44</td>
<td>4.75</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Percent of GDP</td>
<td>6.2</td>
<td>6.4</td>
<td>6.2</td>
<td>6.6</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


a. Government’s basic education spending (development and recurrent including salaries) per population aged 6 to 17.
It is likely that within the projected resource envelope, improvements in efficiency can yield significant improvements in outcomes. The work by Herrera and Pang (2005) shows that Kenya lies well below the education efficiency frontier, although above average for the Sub-Saharan African region. Therefore, both input and output efficiency gains are possible. That is, fewer resources are required to produce the same education results. Moreover, with the same resources, other countries—even in Sub-Saharan Africa—have higher education outcomes. Kenya’s efficiency scores, and how they compare with the best and worst performers in the world, are shown in Table 5-2. Some areas to target for efficiency improvements are discussed below.

Table 5-2: Kenya’s Scores on Measures of Efficiency in Education Sector

<table>
<thead>
<tr>
<th></th>
<th>Most efficient examples</th>
<th>Least efficient examples</th>
<th>Africa region</th>
<th>Kenya</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Indonesia</td>
<td>Chile</td>
<td>Mali</td>
<td>Zimbabwe</td>
</tr>
<tr>
<td>Primary school enrollment (net)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Input efficiency</td>
<td>0.913</td>
<td>0.842</td>
<td>0.679</td>
<td>0.549</td>
</tr>
<tr>
<td>Output efficiency</td>
<td>0.966</td>
<td>0.866</td>
<td>0.382</td>
<td>0.741</td>
</tr>
<tr>
<td>Secondary school enrollment (net)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Input efficiency</td>
<td>0.795</td>
<td>0.733</td>
<td>0.679</td>
<td>0.478</td>
</tr>
<tr>
<td>Output efficiency</td>
<td>0.593</td>
<td>0.813</td>
<td>0.128</td>
<td>0.344</td>
</tr>
<tr>
<td>Learning scores</td>
<td>0.826</td>
<td>1.000</td>
<td>0.291</td>
<td>0.122</td>
</tr>
<tr>
<td>Output efficiency</td>
<td>0.814</td>
<td>1.000</td>
<td>0.430</td>
<td>0.611</td>
</tr>
</tbody>
</table>

Note: Efficiency measures for free-disposable hull analysis of efficiency excluding developed countries.

Improving Teacher Utilization. Teacher salaries are about 80 percent of the education budget. To accommodate the ongoing expansion in school education, there is significant scope for improving teacher utilization through various approaches:

- The national average pupil-teacher ratio (PTR) at the primary level is about 41. This could go up to 43 by 2010, accompanied by the rebalancing of teachers using a differentiated staffing norm of a PTR of 45:1 in high potential areas and 1:25 in Arid and Semi-Arid Land (ASAL) areas, as well as the introduction of multi-grade and multi-shift teaching where appropriate.

- PTRs are positively correlated with school size. Hence, dealing with small schools will also raise efficiency. Establishing limits on the size of school and size of class for operations will encourage merger and multi-grade teaching where necessary and improve the efficiency of teacher use.

- There is considerable scope to increase the amount of time teachers actually spend teaching, which is currently relatively low. It could be done, first, by reducing their administrative load, which could instead be carried by administrative staff; second, by raising the norm for teaching hours per week to a minimum level; and third, by

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90 The focus here is on technical efficiency improvements in primary and secondary education, rather than on allocative efficiency improvements. Government strategies for tertiary, industrial, and vocational education and training (TIVET) and higher education are not yet finalized, which limits the potential to assess the scope or desirability for shifting public resources across subsectors. Furthermore, no work has been done on the social and private returns to investment in education by level in Kenya.
having the duties of teachers who are absent on a part-time basis taken over by colleagues working additional hours.

- Employing short-term and contract/temporary teachers can also help to relieve teacher shortages and improve learning outcomes.\(^\text{91}\)

- Addressing teacher absenteeism could significantly improve value-for-money. Evidence from 2004 in two districts in Western province indicated absenteeism to be a significant problem.\(^\text{92}\) Further analysis is needed to determine the extent and causes of the absenteeism problem in the country as a whole.

- At secondary education level, raising recommended teaching load for courses with high demand, retraining under-utilized teachers, sharing teachers across schools as appropriate, and making full use of contract and especially part-time teachers as appropriate would help improve efficiency.

5.16 Lowering Unit Costs. Making use of mobile schools in the sparsely populated and nomadic parts of the country would lower unit costs and arguably be more effective at keeping children in school. The establishment of boarding primary schools in areas with low enrollment has not been a huge success since many remain underutilized and under-enrolled. To enable an equitable expansion of the secondary system and to save costs, more emphasis should be placed on day schools, as opposed to boarding schools. Table 5-3 shows unit costs in Kenya by level of education.

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005 estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary</td>
<td>69</td>
<td>71</td>
<td>83</td>
<td>88</td>
</tr>
<tr>
<td>Secondary</td>
<td>330</td>
<td>286</td>
<td>287</td>
<td>286</td>
</tr>
<tr>
<td>Technical</td>
<td>292</td>
<td>261</td>
<td>305</td>
<td>363</td>
</tr>
<tr>
<td>University</td>
<td>1,309</td>
<td>1,405</td>
<td>1,508</td>
<td>2,070</td>
</tr>
</tbody>
</table>

*Source: Staff estimates.*

5.17 Reducing Repetition. Reducing repetition would save resources. The overall repetition rate in 2006 was estimated at 6.1 percent, at a cost of about US$ 6.8 million.\(^\text{93}\) The effectiveness of repeating a year as a way to improve education outcomes is questionable.

5.18 Improving Accountability for Household Expenditure. Surveys indicate that households pay on average US$450 per year for each pupil in public secondary school (about 60 percent of the total cost). The figure is much higher than statutory fees, which are about US$71, US$142, and US$213 for day, provincial, and national schools, respectively. Ensuring that out-of-pocket expenditures that go directly to school management are properly and transparently accounted for will improve the incentives for schools to use public resources effectively and improve accountability to parents for use of those resources.

\(^{91}\) Duflo, Dupas, and Kremer (2007).

\(^{92}\) Glewwe and others (1999) found that teachers in one area of Kenya were absent from school 28.4 percent of the time and in school but absent from the class a further 12.4 percent of the time. Further work by Glewwe, Ilias, and Kremer (2004) used evidence from two districts in Kenya.

\(^{93}\) See the background paper, “Efficiency of Government Education Expenditures in Kenya, 2007.”
5.19 Helping the Nonformal Sector. Nonformal schools can provide a cost-effective alternative to expand service provision, especially in hard-to-reach areas. Registered nonformal schools that have adopted the 8-4-4 education system are eligible for textbook grants from the Ministry of Education. Bringing more of them on board would certainly help the poor access education—even outside the formal system. The quality of the education in nonformal schools needs further examination. These schools typically employ teachers outside of the Teachers Service Commission “quality control” mechanism and their physical buildings are often in need of significant renovation. The Ministry of Education (MoE) should also examine ways in which it can help improve the quality of the facilities at these school sites by offering matching capital grants, for example, as well as by monitoring exam performance in order to assess good (and bad) performance in nonformal schools. Publicizing the exam results of nonformal schools will also help parents make informed decisions when choosing a nonformal education establishment.

5.20 Efficiency Improvements at the Primary Education Level. Regular provision of learning materials in the classroom can lead to a reduction in repetition and dropout rates. This is the finding of an analysis of internal efficiency gains in the context of the Free Primary Education Support Project (FPESP). The repetition rate in the highest poverty band (more than 70 percent of children from poor families) fell from 9.2 percent in academic year 2002 to 7.7 percent in 2005. The overall primary school dropout rate was reduced from 2 percent in 2003 to 1.5 percent in 2006. The primary completion rate improved from an estimated 68.2 percent to 77.6 percent in 2006.

5.21 Other Ongoing Efforts to Improve Efficiency in the Education Sector. A number of promising measures are underway. The government’s commitment to introducing efficiency measures is evident in the “audits for value,” which are undertaken in the education sector on a fiscal year basis, and on the public expenditure tracking surveys (PETS), which are expected to feature as a biennial exercise. Furthermore, from a technical perspective, the employment of teachers on a contract basis is being actively piloted in various parts of the country. In the context of the Kenya Education Sector Support Program (KESSP), MoE has committed to adopting the recommendations of the Teaching Norms Study completed in 2005, encouraging nonformal education, and addressing other supply-side constraints to access for all school-age children. The government has developed the Secondary Education Strategy in anticipation of the increase in primary school graduates. Government strategies for Technical, Vocational and Educations Training (TIVET) and higher education are also being developed. In the context of operationalizing the strategies, the Ministries of Education, and Science and Technology are focusing on introducing efficiency measures within the TIVET and higher education subsectors. There is also potential to assess potential alloative efficiency measures and the scope and desirability of shifting public resources across subsectors. Analytical work by the World Bank and the Ministry of Education is envisaged in the near future for calculating the social and private returns to investment in education, by levels of education, in Kenya.

Health

5.22 The key challenge in the health sector is to reverse a decline in health indicators. This has been recognized by the government and is the main objective of the National Health Sector Strategic Plan II, 2005-10 (NHSSP, GoK 2005b). Although still lower than many Sub-Saharan

94 FPESP Implementation Completion Report, World Bank.
95 See also the recommendations of the recently concluded study of the Task Force on Affordable Secondary Education, Ministry of Education, Science and Technology, GoK.
African countries, infant and childhood mortality rates increased between 1993 and 2003, with malaria constituting the main cause of deaths. The government has adopted a number of new measures to bring malaria under control. These include the adoption in 2006 of a new drug (coartem) for malaria treatment, national insecticide-treated bednet programs, and intensified vector control. These measures have brought about a substantial decline of up to 44 percent in child mortality due to malaria in high-prevalence districts. HIV prevalence has also improved, with rates estimated at 5.1 percent of the adult population in 2006, down from over 10 percent in the 1990s. However, the prevalence of HIV/AIDS has led to an upsurge in tuberculosis (TB). There are at least 1.2 million Kenyans now living with HIV/AIDS and tuberculosis, and the country's estimated TB incidence rate of 620 per 100,000 is one of the highest rates in the world.

5.23 The indicators of health service delivery show mixed results. The proportion of women of reproductive age receiving family planning commodities has risen from 10 percent in 2004/5 to 43 percent in 2006/7. The proportion of HIV-positive pregnant women receiving prevention of mother-to-child transmission treatment has increased from 10 percent to 29 percent over the same period. Immunization coverage improved from 59 percent in 2003 to 71 percent by 2006/7, but then fell to just 51 percent in the first five weeks of 2008 due to the post-election crisis.

5.24 Nevertheless, access to health and medical care services is unequal across the country. The inequalities reflect health systems weaknesses and inefficiencies that have led to leakages and wastage, shortage and unequal distribution of personnel, poor flow and low utilization of funds at lower facilities, and reliance on input-based rather than output-based financing and resource allocation. Regional disparities imply that the need to improve access to health services is most acute in the Coast, Nyanza, Western, and North Eastern provinces.

5.25 Encouragingly, recent fiscal trends show an increase in government spending on health. Table 5-4 shows that between 2002 and 2005, recurrent government expenditure on health increased by 37 percent. Total government health expenditure is projected to increase by a further 50 percent between 2006/07 and 2009/10. That said, it is important to note that actual government expenditures often fall short of budgeted projections, particularly in the case of development expenditures, and that comparisons of estimated and actual spending figures can be very misleading. For example, actual health expenditures in 2005/06 were 23 percent (K Sh7 billion) below the voted budget of K Sh 30.4 billion. Execution of external aid-financed health projects is particularly problematic, and implies the need to be cautious in using future projections of external assistance. Total per capita health spending (including external assistance) is estimated to be approximately US$24 (WDI estimates total per capita health spending for 2004/05 to be around US$24, as do total public spending estimates for 2006/7). This is some US$7 per capita short of the WHO recommendation of US$34 per capita, but is slightly above both the United Nations Development Programme (UNDP) estimates of spending per capita to achieve the health Millennium Development Goals (MDGs) (US$23) and the government’s estimate for an essential health care package (US$22).96

96 Private health expenditures are estimated to be an additional 2 percent of GDP. According to the 2002 National Health Accounts, private health expenditures were 54 percent of total health spending.
Table 5-4: Total Health Expenditures, 2002/03–2009/10

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual K Sh billions</td>
<td>Estimates</td>
<td>Projections</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total public sector</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>53.7</td>
<td>61.4</td>
<td>48.6</td>
<td>58.4</td>
<td></td>
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<tr>
<td>Government expenditure</td>
<td>154</td>
<td>16.4</td>
<td>19.2</td>
<td>23.0</td>
<td>35.0</td>
<td>38.9</td>
<td>43.1</td>
<td>53.1</td>
</tr>
<tr>
<td>Recurrent</td>
<td>14.4</td>
<td>15.4</td>
<td>17.4</td>
<td>19.8</td>
<td>21.1</td>
<td>22.9</td>
<td>25.2</td>
<td>30.1</td>
</tr>
<tr>
<td>Development</td>
<td>1</td>
<td>1</td>
<td>1.7</td>
<td>3.2</td>
<td>13.9</td>
<td>16</td>
<td>17.9</td>
<td>23</td>
</tr>
<tr>
<td>External assistance</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>18.7</td>
<td>22.5</td>
<td>5.5</td>
<td>5.3</td>
</tr>
<tr>
<td>Government health spending</td>
<td>6.3</td>
<td>6.5</td>
<td>7.5</td>
<td>9.5</td>
<td>15.6</td>
<td>17.3</td>
<td>19.2</td>
<td>23.6</td>
</tr>
<tr>
<td>Total public health spending</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>23.9</td>
<td>27.3</td>
<td>21.7</td>
<td>26.0</td>
<td></td>
</tr>
<tr>
<td>Total health spendinga</td>
<td>20.1</td>
<td>--</td>
<td>24.3</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td></td>
</tr>
<tr>
<td>Per capita US$</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>26.7</td>
<td>26.3</td>
<td>26.1</td>
<td>26.3</td>
<td></td>
</tr>
<tr>
<td>Government expenditure</td>
<td>1.49</td>
<td>1.51</td>
<td>1.55</td>
<td>1.5</td>
<td>2.0</td>
<td>2.0</td>
<td>1.9</td>
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</tr>
<tr>
<td>External assistance</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>1.1</td>
<td>1.1</td>
<td>0.2</td>
<td></td>
</tr>
<tr>
<td>Private health spendingb</td>
<td>3</td>
<td>3</td>
<td>2</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Source:** Appropriation Accounts, various years, Government of Kenya, World Bank WDI 2007, staff estimates.

**Note:** Spending on health excludes Constituency Development Fund (CDF) expenditures and other GoK health expenditures outside of the Ministry of Health. Actual expenditures for 2002/3 and 2003/4 have been audited; 2004/5 and 2005/6 are Treasury reported actuals; 2006/7 are estimates; 2007/8 are budgeted (printed estimates); and 2008/9 and 2009/10 are budget projections.

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5.26 The government budget, external assistance, and household expenditures for health are all sizeable; thus improving efficiency and effectiveness of public sector spending is of paramount importance. It is also important to address donor disbursement and coordination issues that affect donor-financed health services, and regulation and service provider accountability to protect and improve services for the individuals who pay out of their pocket. Of particular importance will be the effective implementation of the new Health Sector Services Fund, that is being established to promote the efficient flow of resources to local health facilities throughout the country.

5.27 **Improving Efficiency of Hospital-provided Services.** Curative care constitutes around half of the government’s health spending, and 80 percent of this amount goes toward salaries. Approximately 18 percent of the government’s recurrent budget is allocated to the tertiary hospital sector, which suffers from financial management weaknesses. This has lead to leakages and misappropriation of resources and/or disparities in budget versus expenditures. The financial management difficulties mean allocated resources do not reach their intended destination. The improvements in funds flow and accountability arrangements that are being developed by the government need to be implemented as soon as possible.

5.28 It appears likely that a substantial number of tertiary cases could be treated in general secondary hospitals, and perhaps even primary care facilities, more easily and at lower cost. Greater use of district hospitals (where possible) could lower overall unit costs of hospital care. A simple comparison of Kenyatta and Moi hospitals with provincial and district hospitals shows that the average cost per inpatient day is about half, and the average cost per discharge is about 40
percent, of that of the Kenyatta and Moi hospitals. However, such a change in patterns of use is unlikely to take place without careful planning by stakeholders to improve access and quality of care at lower levels—and hence shift incentives for users—and rebalancing staff to these lower-level institutions.

5.29 Improved Use of Medical Personnel. As in the case of teachers, there is scope to rebalance staff to address shortages and improve productivity. Unlike other countries in the region, Kenya has a pool of health sector workers who would be available for employment. A recent “Emergency Recruitment” of staff funded through the U.S. Agency for International Development (USAID) showed that of the total of 6,566 people who applied for 677 positions, about a third were considered qualified but were not currently employed. Public sector health staff, recruitment, and retention policies and incentives also need to be examined to address staffing shortages where they are most critical. A human resources survey found some under-utilization of existing staff and the possibility of relocating up to 110 doctors and 2,300 nurses from district and provincial hospitals to health centers and dispensaries.

5.30 Access to Specific Health Interventions. Under the auspices of NHSSP, backed by financing by development partners, there has been progress in improving health interventions. There is still considerable scope to scale up interventions—such as immunization, antenatal care visits, anti-retroviral (ARV), and malaria prevention—to prevent and control infectious disease and so limit the demands on the health system further down the line.

5.31 Improving Efficiency in Drug and Non-pharmaceutical Use. Drugs and medical supplies are around 15 percent of government’s recurrent expenditures, amounting to K Sh 3.2 billion in 2007/8, and 54 percent of the development budget, a further K Sh 7 billion. In addition, in-kind supplies are often provided as contributions from the donor community for specific service delivery programs such as malaria, immunizations, and HIV/AIDS, as well as for reproductive health commodities. If the unpredictability and risks of relying on external funds and contributions can be minimized, this could provide the Ministry additional spending flexibility. Improved harmonization of commodities procurement is a cornerstone of current joint initiatives between the Ministry of Health (MoH) and its development partners.

5.32 Decentralization. The concentration of authority over resources at the national level curtails the flexibility of the districts in planning for, and use of, the allocated resources. A 2004 Public Expenditure Tracking Survey (PETS) found that health facilities such as dispensaries and health centers do not take part in the procurement processes, which resulted in poor quality and unnecessary drugs being procured and supplied. Inflexible rules governing the use of funds resulted in slow budget execution. Thus the centralized budget and cash management limits flexibility and tends to undermine the districts’ ability to utilize their budgets fully, culminating in reduced services. Cognizant of these problems, the MoH has initiated various measures to increase the autonomy of lower level facilities, including “pull” rather than “push” systems of drug and medical supply distribution and the use of Health Facility Funds to allow facilities to make decisions over their own needs for operations and maintenance. Of course, adequate training and preparation of staff at the lower levels is essential to ensure a smooth rollout of promising pilot projects throughout Kenya, and these initiatives are currently being pursued.

5.33 The sector has also suffered from serious governance problems, but steps are being taken to address them. Since 2004, a series of reviews and special audits have identified a range of

97 More detailed cost calculations are being undertaken by the Ministry of Health, which should shed more light on the potential efficiency gains.
problems in the sector, including weaknesses in financial management, lack of fraud risk management, limited oversight, and inadequate procurement procedures and practices. Lack of transparency and accountability has also been found to obstruct service delivery. For example, the 2004 PETS found leakage in the supply chain of drugs and vaccines, and Transparency International found a rising case of leakages of antiretroviral drugs. However, there are already signs of improved management in the health sector with some good results. Performance-based contracts are now in place for the sector leadership at the national and provincial levels. Social accountability by public facilities is being enhanced with the establishment of a Citizen's Charter, District Health Management Boards and Facility Management Committees, which provide oversight by civil society in the management of public facilities. These initiatives appear to be having some impact. For example, the results of the 2007 Client Satisfaction Survey showed that, of patients who indicated that it was not their first time to visit the sampled facility, 89 percent reported improvements.

5.34 Donor Disbursement Issues. A study conducted in 2004 reported that a significant proportion of donor resources were not used because of centralized channels of control. Many donors bypass the MoH and Treasury systems and provide funding off-budget as a way of fast-tracking project implementation and achieving faster results. One downside is that this can weaken the public system by making it more difficult for the government to plan and program resources it has control over to health priorities not benefiting from off-budget assistance. Donor harmonization efforts are seeking to minimize the adverse impacts of off-budget financing.

5.35 Development Vote Expenditure Issues. There is a need to examine closely the reasons for the low level of development budget execution. A recent review of health expenditures revealed that there are particular issues in the “Preventive and Promotive Health” sub-vote (where execution was as low as 24 percent), which had received almost half the approved development budget. Raising the execution rates of development budget back to the 2001/2 level of 67 percent would make available an additional K Sh 3.4 billion into the publicly financed health system.

Roads

5.36 The budget for roads has grown quickly in the past three years and is set to expand further. The fiscal challenge is of two types. First, the Roads Department has a history of low budget execution, which means that increased allocations are unlikely to translate completely into increased spending. Second, value for money is low. Road projects were and still are not chosen based on traffic assessments, let alone sound economic appraisal or cost-benefit analysis. As a result, there are several examples of high priority roads that have not yet made it into the portfolio, as well as examples of roads that are included but should not have been a priority. Stakeholders from the productive sectors, such as manufacturing, flower, and tourism boards, have argued that important roads affecting their businesses are not included in the budget. Moreover, poor management and lack of accountability and transparency in transactions have led to inefficient execution of works, leading to sizeable cost and time overruns and dubious quality of works. A review carried out in 2007 showed that out of 207 ongoing projects, 35 showed a cost overrun. In the case of these 35 projects, the markup reached about 80 percent of the original contract sums, totaling some K Sh 7 billion. Time overrun was even more serious: 57 percent of

98 The government is giving priority to addressing the backlog of maintenance and rehabilitation over the expansion of the network. However, within the area of maintenance and rehabilitation, there is no prioritization at project level. There is no recent traffic assessment, which could allow proper economic analysis.
the ongoing portfolio exceeded the original construction completion time at the tender stage. On average, the actual time for completion was more than twice that estimated at the tender stage.

5.37 The roads sector is predominantly government-owned and government-funded. Improving value for public monies requires improvements at almost all stages of the standard project cycle.

5.38 **Improve Planning and Preparation of Projects.** Insufficient upfront planning and preparation of projects is the biggest cause of inefficiencies. Poorly prepared projects lead to delays in implementation, poor quality in initial design, rushed redesign later on, cost, and time overruns, and changes in the scope of works to fit the available budget. At present there is no requirement that projects identified to be financed from the central budget meet any specific level of preparation or economic appraisal (such as a cost-benefit analysis) to ensure that they are feasible and have an economic rate of return above a threshold. The government (through the Ministry of Finance) should establish common guidelines for selection and appraisal of road projects. This should include establishing a project cycle, identifying selection criteria, specifying decision stages, and integrating the project cycle with the timing of the budget processes. The existing Kenya Roads Board guidelines provide a useful starting point. Incentives to stop poor costing practices need to be introduced, such as sanctions for under-costed projects.

5.39 **Choose Projects with High Rates of Return.** An economic appraisal should be required for all projects costing over a certain minimum threshold. Not all projects may need cost-benefit analysis for their prioritization (for example, Class D and E roads), but they do need to pass explicit and transparent criteria for inclusion in the public investment program and budget. The result should be a multiyear investment program based on appraised and priority-ranked projects, which is then included as a part of Medium Term Expenditure Framework (MTEF).

5.40 **Adhere to Good Procurement Procedures and Practices.** Putting an end to the lax procurement procedures and practices will improve economic efficiency enormously. There are credible concerns of corruption. Now that there is a modern framework for procurement in the government, ensuring transparency, fairness, efficiency, and accountability in procurement procedures and practices is just a matter of implementation.

5.41 **Strengthen Supervision, Monitoring, and Evaluation.** Overall portfolio management can be strengthened using agreed indicators of portfolio health or performance. Similarly, procurement could be tightened by developing standards or norms for various steps in the procurement process. There is a need for continuous monitoring during the entire implementation process to help identify potential problems so that they can be addressed early. In this regard, the government should consider developing a system of measuring risks associated with each project so that intensity of supervision could be related to the riskiness of a project. The MoF should demand annual reports on the indicators of portfolio health and the network condition provided by each roads agency as part of the budget cycle.
6. MOBILIZING PRIVATE RESOURCES FOR INFRASTRUCTURE

6.1 Kenya has used private participation in infrastructure (PPI) in all the major infrastructure sectors for leveraging public resources and donor funding, and improving the efficiency of these sectors. From 1990 to 2007, PPI in Kenya attracted $US3.64 billion in investment commitments, about 6 percent of the flow to Sub-Saharan Africa during this period (Table 6-1). The telecommunications sector accounted for the overwhelming majority—about 72 percent—of these investment commitments. Appendix Table A-6 lists all PPI projects in Kenya to date. The pace of transactions has quickened in the past two years. The current government remains committed to PPI; in the FY08 budget speech, the Minister for Finance reiterated that PPI remains a strategic objective.99

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td>No. of projects</td>
<td>Total investment (US$ billion)</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>146</td>
<td>32.77</td>
</tr>
<tr>
<td>Energy</td>
<td>82</td>
<td>7.65</td>
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<tr>
<td>Transport</td>
<td>82</td>
<td>10.03</td>
</tr>
<tr>
<td>Water and sewerage</td>
<td>22</td>
<td>0.15</td>
</tr>
<tr>
<td>Total</td>
<td>332</td>
<td>50.59</td>
</tr>
</tbody>
</table>


6.2 An analysis of Kenya’s past experience with PPI shows that the results have been mixed.100 Overall, Kenya like many other developing countries, has received little private investment in infrastructure other than mobile phone networks. At the level of individual transactions, some of the contracts were doomed from inception because they had a flawed design

99 Several transactions have taken place since 2006. In the energy sector, Kenya Electricity Generating Company (KenGen) issued 30 percent of its shares to the public in 2006; Kenya Power and Lighting Company (KPLC) entered into a two-year management contract with Manitoba Hydro in July 2006. The contracts for two more independent power producers (IPPs) have been awarded. In the transport sector, the Rift Valley Railways concession for the Kenya-Uganda railway closed in November 2006. In November 2007, a decision was taken to transfer 51 percent stake in Telkom Kenya to France Telecom, in consortium with Dubai-based Alcazar Capital Limited. Further, the Treasury plans to sell 25 percent of its 60 percent stake in Telkom Kenya.

100 See the background paper, “Public-Private Partnerships in Kenya. Past Trends and Future Directions.”
and the government was not committed to make them work (such as the Felixstowe Port Consultants management contract for Mombasa container terminal). Others, like the Westmont Power Project, were hurriedly drawn up in a nontransparent fashion, and therefore could not be sustained. However, there have also been successes, most notably in the telecommunications sector, as the service is expanding at a scorching pace.

6.3 The important reasons for the success of PPI in the telecommunications sector were the reasonably long concession period, favorable initial conditions in the form of cost-covering user charges, and development of regulatory institutions. The reasonably long concession period mitigated commercial risk of the private operators by providing them assurance that they would be able to recoup their high level of investment. The cost-covering user charges ensured that there are no substantive political economy issues associated with the entry of the private sector in telecommunications. The regulatory institution in the form of the Communication Commission of Kenya (CCK) addressed the regulatory risk of the operators.

6.4 Overall, however, it can be said that Kenya has followed an unstructured approach to PPI until now. The infrastructure deficit of Kenya and its experience with PPI highlights the need for a more structured and successful approach for future transactions. The discussion below first presents general lessons about the enabling environment for PPI and important policy-level issues relating to design of transactions—without getting into details, which would vary from one project to another. The section that follows briefly discusses institutional arrangements that should be put in place before undertaking PPP transactions on a larger scale.

6.5 Competitive Markets. The experience with telecommunications sector suggests that privatization per se does not lead to increases in coverage, but that it does when combined with an effective regulatory regime and competition. In Kenya, competition among service providers has led to rapid expansion of the telecommunications network. Competition is also useful in avoiding renegotiation of concession contracts by increasing government leverage in thwarting such requests.

6.6 Regulation. Independent regulation mitigates political risk for private service providers by creating a level playing field. In addition, it promotes accountability and performance by setting price caps and quality standards, and by monitoring and enforcing compliance with them. Regulation also facilitates dispute resolution. The recent public wrangling between KenGen and KPLC regarding their interim power purchase agreement demonstrates that there is a relatively high degree of regulatory risk in the power sector, where the Energy Regulatory Board (ERB) has yet to establish credibility. In telecommunications, on the other hand, the Communications Commission of Kenya (CCK) has been able to mitigate regulatory risk. There is no regulator yet in the transport sector, which is likely to hamper successful private participation in the road and port sectors.

6.7 Development of the Local Capital Market. Kenya has pension fund assets estimated at US$4 billion—almost 15 percent of 2006 GDP—which can be productively utilized for infrastructure financing. Development of the local capital market, besides making debt and equity funding available for infrastructure, would also provide hedging opportunities and thus help in managing foreign exchange risk. The issue of developing local currency bond markets and attracting institutional investment into infrastructure is discussed in the next section.

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101 Hedging opportunities refer to the development of derivative markets in future.
6.8 The Importance of Managing Politics. There are always vociferous losers from private sector participation: inefficient workers of the affected public sector units organized in powerful unions, bureaucrats of the controlling ministries who would see their fiefdom shrink, and politicians who would see their power of patronage at state expense whither. The unsuccessful privatization of the Mombasa container terminal is a prime example, where political considerations have delayed a good economic decision. Confidence and trust can be built in the PPI process by involving stakeholders, maintaining transparency, and generating quick results. The potential welfare gains from service provision through PPI should enable the winners to compensate the losers (most notably laid-off workers through, for example, an attractive severance package, as in the case of Telkom Kenya Limited).

6.9 Risk Allocation. Risk mitigation is the key to successful PPI projects. The objective should be to assure the private investor of a market-driven return at a reasonable level of risk, and the user of adequate service quality at affordable costs. The different types of risks associated with infrastructure projects, and the agency that should handle them, are shown in Table 6-2.

<table>
<thead>
<tr>
<th>Type of Risk</th>
<th>Who Should Bear It</th>
</tr>
</thead>
<tbody>
<tr>
<td>Political risk, including expropriation, inconvertibility, or nontransferability</td>
<td>Government should bear the risk. In case of contract termination, compensation should be paid by the government.</td>
</tr>
<tr>
<td>Concession design or development risk</td>
<td>Government should bear the risk.</td>
</tr>
<tr>
<td>Construction risk (within private partner’s control)</td>
<td>Private partner should bear the risk through fixed price construction contracts plus liquidated damages.</td>
</tr>
<tr>
<td>Construction risk (outside private partner’s control: government action that delays the project, such as delays in obtaining approvals or permits)</td>
<td>Government should bear the risk.</td>
</tr>
<tr>
<td>Commercial risk</td>
<td>Private partner should bear the risk.</td>
</tr>
<tr>
<td>Financial risk</td>
<td>Private partner should bear the risk, as it is a commercial risk. Government can help through macroeconomic stability.</td>
</tr>
<tr>
<td>Exchange rate risk</td>
<td>Private partner should bear the risk.</td>
</tr>
<tr>
<td>Interest rate risk</td>
<td>Private partner should bear the risk.</td>
</tr>
<tr>
<td>Solvency risk</td>
<td>Private partner should bear the risk.</td>
</tr>
<tr>
<td>Unexpected event risk (Acts of God like floods, earthquakes)</td>
<td>Insurer’s risk, if risk is insured. Otherwise, risk should be borne by private partner.</td>
</tr>
<tr>
<td>Unexpected event risk (Changes in legal or contractual framework directly affecting the project)</td>
<td>Government should bear the risk.</td>
</tr>
<tr>
<td>Regulatory risk</td>
<td>Private partner bears this risk. Government should set up credible regulatory institutions to mitigate this risk.</td>
</tr>
<tr>
<td>Renegotiation risk</td>
<td>Government bears this risk. Government should design proper concession agreements and regulatory framework to mitigate this risk.</td>
</tr>
</tbody>
</table>

Table 6-2: Types of Risk and their Allocation in a Typical PPI Project

---

*a. This is what the government should strive for. In the interim, until there are credible regulators, regulatory risk will largely need to be covered through government guarantees or World Bank partial risk guarantees, which are countersigned by the government.

Source: Prepared by staff from various sources.

73
6.10 User Fees. There is especially a need for consensus on this aspect before PPI can play a useful role. Legally binding contracts with the private operator and a hard budget constraint for them mean that the issue of cost-covering user fees cannot be addressed in vague terms. Appropriate user fees are also necessary for financial closure of projects and their post-commissioning sustenance. The government could consider some form of subsidy to shield the poor from full recovery of costs and build it into the contractual terms.

Developing Institutional Support for Public Private Partnerships

6.11 Institutional Arrangements. Public private partnership (PPP) projects involve considerable potential financial liabilities for the government; therefore, adequate institutional arrangements need to be in place for project analysis, negotiation, implementation, and monitoring of transactions. Well-defined institutional arrangements such as competitive bidding, clear bid evaluation criteria, disclosure of winning bidder and the bid price, and putting the transaction agreements in public domain to provide oversight are also needed to make the process transparent. The study funded by the Public-Private Infrastructure Advisory Facility (PPIAF) on the legal, policy, and institutional framework for PPP (IP3 2007) has suggested potential institutional arrangements, which can be drawn upon by the government.

6.12 The government can demonstrate its commitment to PPP by publishing a policy in the National Gazette. At this stage, there may not be a need to pass a new law, as there are no restrictions on PPP in the existing laws of Kenya. As suggested in the PPIAF study, amendments to the Public Procurement and Disposal Act, Government Contracts Act, and Permanent Secretary to the Treasury (Incorporated) Act, as well as subsidiary legislation in the form of regulations, would help codify the institutional set-up for PPP. While the proposed amendments will clarify the legality of PPP, the regulations are needed to define the responsibilities and obligations of the Public Procurement Oversight Authority, the Privatization Commission, line ministries, state corporations, and local government vis-à-vis the Ministry of Finance.

6.13 The government should consider establishing a PPP Secretariat in the MoF and use it to evaluate PPP undertaken by line ministries. A few PPPs with large value are currently being negotiated by line ministries with minimal involvement from Treasury. The line ministries have limited experience with financial analysis and structuring PPP, thus potentially exposing the government to fiscal risks. The PPP Secretariat would ensure that PPP negotiated by line ministries are affordable, that they generate adequate value for money to the government, that there is appropriate risk transfer, and that contingent liabilities are accounted for. In the interim, the MoF should take stock of all large PPPs that are in the procurement stage to ensure that such deals are both affordable and do not result in a level of financial exposure that is unacceptable.

6.14 Based on the pipeline of PPP projects, the PPP Secretariat should start small and be scaleable. The project pipeline should be one of the key factors in determining the size, composition, and mandate of the PPP Secretariat. In many countries, the lack of a robust PPP pipeline has led to unsuccessful PPP units. The pipeline of PPP projects over the next few years is modest and includes several projects that have long been under consideration; however, there are some potentially large transactions (see Table 6-3). Based on international best practice, it needs to be stressed that the PPP Secretariat should have no role in promoting individual PPP transactions, in order to prevent a conflict of interest.
Table 6-3: Tentative PPI Project Pipeline

<table>
<thead>
<tr>
<th>Project</th>
<th>Sector</th>
<th>Type of PPP</th>
<th>Status</th>
<th>Expected completion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kinangop: wind power (30 MW)</td>
<td>Energy</td>
<td>Joint venture</td>
<td>In development</td>
<td>2007</td>
</tr>
<tr>
<td>OrPower, Olkaria III: geothermal (35 MW)</td>
<td>Energy</td>
<td>BOOT(^a)</td>
<td>Contract awarded</td>
<td>2008/9</td>
</tr>
<tr>
<td>Olkaria IV: geothermal (70 MW)</td>
<td>Energy</td>
<td>BOOT(^a)</td>
<td>In procurement</td>
<td>2009/10</td>
</tr>
<tr>
<td>Rabai Plant, Mombasa: diesel (80–90 MW)</td>
<td>Energy</td>
<td>BOOT(^a)</td>
<td>Contract awarded</td>
<td>2008</td>
</tr>
<tr>
<td>Eldoret-Kampala Oil Pipeline Extension</td>
<td>Energy</td>
<td>BOOT(^a)</td>
<td>Contract awarded</td>
<td>2007/8</td>
</tr>
<tr>
<td>Nairobi Urban Toll Road</td>
<td>Transport</td>
<td>BOT(^b)</td>
<td>Contract awarded</td>
<td>2007</td>
</tr>
<tr>
<td>Mombasa Road</td>
<td>Transport</td>
<td>Concession</td>
<td>Under consideration</td>
<td>--</td>
</tr>
<tr>
<td>Thika Road</td>
<td>Transport</td>
<td>Concession</td>
<td>Under consideration</td>
<td>--</td>
</tr>
<tr>
<td>Mombasa Port: container terminal</td>
<td>Transport</td>
<td>Concession</td>
<td>Under consideration</td>
<td>--</td>
</tr>
<tr>
<td>Lamu Port Development</td>
<td>Transport</td>
<td>Concession</td>
<td>Under consideration</td>
<td>--</td>
</tr>
<tr>
<td>Kenyatta Airport: passenger terminal</td>
<td>Transport</td>
<td>Concession</td>
<td>Under consideration</td>
<td>--</td>
</tr>
<tr>
<td>Kisumu Airport</td>
<td>Transport</td>
<td>Concession</td>
<td>Under consideration</td>
<td>--</td>
</tr>
<tr>
<td>TEAMS: fiber optic cable</td>
<td>Telecom</td>
<td>Joint venture</td>
<td>Finance being sought</td>
<td>2008</td>
</tr>
<tr>
<td>EASSY: fiber optic cable</td>
<td>Telecom</td>
<td>Joint venture</td>
<td>Finance being sought</td>
<td>2008</td>
</tr>
<tr>
<td>Community piped water supply projects</td>
<td>Water</td>
<td>BOO(^c)</td>
<td>Under consideration</td>
<td>--</td>
</tr>
</tbody>
</table>

* a. BOOT=build, own, operate, transfer.  
  b. BOT=build, operate, transfer.  
  c. BOO=build, own, operate.

*Source:* Prepared by staff using data from PPIAF database, World Bank and other sources.

**LOCAL CURRENCY FINANCE OF INFRASTRUCTURE**

6.15 Local financial markets have the potential to make a large contribution to financing infrastructure in Kenya (Box 6-1). Pension funds and long-term insurance companies hold the most potential.

**Box 6-1: Supply Potential of Long-term Local Currency Finance in Kenya**

In March 2007, pension funds, including the National Social Security Fund (NSSF), had K Sh 223 billion in assets. Thirty percent of these assets (about K Sh 67 billion) can be invested in corporate bonds such as infrastructure-related securities, but are largely invested in government securities. Within pension funds, restructuring of NSSF portfolio, which has 95 percent of assets invested in equity and property, could release K Sh 18 billion (30 percent of total assets in December 2005). Long-term insurance companies had K Sh 45.6 billion in assets in December 2005 and government securities represented about 45 percent of total assets.

Banks are reluctant to provide sizable long-term finance partly because their liabilities (deposits) have short maturities. However, an active corporate bond market would allow banks to raise finance with longer tenors, which could then be on-lent at a correspondingly longer term. Several factors could aid a more active role for banks in infrastructure through project finance, including an efficient inter-bank market (where banks typically raise funding on draw-downs), consolidation in the banking sector, and the development of structuring skills. In developed markets, bank financing for infrastructure is generally cheaper during the construction and initial operating phase than funding from capital markets, as banks benefit from information advantages and the ability to enact stricter covenants. However, once the project is operating smoothly, refinancing through the bond market may offer better pricing.
Developing the Corporate Bond Market

6.16 Developing the corporate bond market is important for long-term financing of infrastructure through capital markets. However, there are several obstacles to the development of a healthy bond market at present:

- The major impediment is an ill-suited regulatory framework. Many countries, such as Brazil, the Republic of Korea, and Malaysia, have successfully developed their bond market by shifting to a regulatory environment that focuses on disclosure. In contrast, the Capital Markets Authority (CMA) in Kenya operates a merit-based system, where it has on occasion used its own discretion in a nontransparent manner to decide which companies can access the bond market. This filtering process has turned the regulator largely into a bottleneck.

- Over-regulation of secondary market activity (such as the lack of an Over-the-Counter market) could be stifling liquidity. The requirement that corporate bonds must be traded on the Nairobi Stock Exchange (NSE) closes down a channel for introducing liquidity into the market. The negotiation of the instrument by dealers and institutional investors in the Over-the-Counter (OTC) market is the predominant practice around the world. To maintain transparency, it is advisable that corporate bonds continue to be listed on the Nairobi Stock Exchange; however, where they are traded is best left up to the trading parties.

- Private placements can reduce the overall costs of a bond issuance. One of the advantages of private placements is that it shortens the time it takes companies to access the market. The current regulatory framework does not encourage companies that prefer to remain private or issues with more complex structures to access institutional investors through a more appropriate channel such as a private issue. In the case of infrastructure bonds, these are likely to be structured products targeted toward institutional investors. If the concern is that such instruments could reach the hands of unsophisticated investors, there are ways of addressing this: for example, by requiring that the denomination of the notes is high enough that they are only affordable for institutional investors.

- Lower fees would make bonds much more attractive to companies from a pricing perspective. Bond issuance fees are becoming more competitive with the arrangement fees on bank loans. By most accounts, issuance fees for corporate bonds have historically ranged from 3 to 4 percent, as compared to 1 to 2 percent for bank loans.

- Under CMA practice, many issuers are required to obtain a credit guarantee. The de facto requirement for credit guarantees has led enterprises to view bonds as unaffordable. Guarantees can add as many as 300 to 400 basis points in cost for the issuer. Going forward in a disclosure-based environment, the CMA would allow the market to determine the risk premium and structure of bonds issuances. In order to stimulate the development of the corporate bond market and ensure its stability, the CMA might require in the interim that companies obtain a rating.
• The several months that it takes to get a bond approved (six months, in some cases) encourages parastatals and companies to source financing from banks. One reason for the proposed switch to a disclosure-based regulatory framework for the corporate bond market is to shorten the approval process.

6.17 The issuance of asset-backed securities (ABS) regulations will make it easier for infrastructure firms to access long-term finance. In fiscal year 2004/5, the CMA developed regulations for asset-backed securities. The regulations were adopted in late 2007. Once implemented, the asset-backed securities regulations could be a major catalyst in mobilizing long-term resources for infrastructure.

6.18 A certification program for various capital market players would help improve the professionalism of the securities industry. Currently, there are no industry standards for key activities of the market such as trading, asset management, and investment banking. The CMA carries out basic controls over certain segments of the market through its licensing process.

6.19 The supervisory and enforcement capacity of market authorities needs to be strengthened. There are two ways that this can be done: by centralizing all supervision of the market and market participants at the CMA; or by establishing an independent self-regulatory organization (SRO), assuming the Nairobi Stock Exchange demutualizes. The SRO option may be better suited to the circumstances in Kenya, as it provides for more wage flexibility and for surveillance by market practitioners with the requisite skill-set. The development of SRO capacity would also lessen the burden on the CMA to oversee every facet of the market.

6.20 Establishing the Privatization Commission and proceeding with planned initial public offerings (IPOs) and secondary offerings will deepen capital markets. There is still substantial demand for new securities among institutional and retail investors.

6.21 Private sector representation is lacking on the board of directors of partially privatized infrastructure parastatals. Those infrastructure state-owned enterprises that have done IPOs continue to have boards dominated by government, thus undercutting one of the reasons for privatization (that is, private sector management). Once established, it is advisable for the Privatization Commission to prioritize among different methods of privatization. Based on international experience, selling a portion of equity to a diffuse ownership base (through an IPO, for example) typically does not lead to an improvement in performance. On the other hand, selling a stake to a single strategic investor often brings with it management experience and technological knowledge gained from years of experience in the sector. While selling stock through an IPO does have the benefit of “allowing Kenyans to own a part of Kenya,” the government needs to balance this objective with doing what is likely to improve best the performance of infrastructure utilities and the delivery of services.

Improving Banking Sector Efficiency

6.22 The government continues to exercise de facto control over four banks (Consolidated, Co-op, KCB, and NBK) and has injected large amounts of financial assistance to maintain the solvency of three of these, Co-op, KCB, and NBK. The analysis carried out for this report shows that government-influenced banks have lagged private banks in improving banking efficiency during the past five years. They also have much higher share of their loan portfolios as non-performing and their overhead costs are higher. The governance of the state-influenced banks also poses a long-term fiscal risk given their history of questionable lending by these banks. The government had laid out an agenda for financial sector reform in the ERS but progress has been
limited in the area of improving the efficiency of public-influenced banks. Among the suggested steps to take the reform process forward are: (i) reduce government influence in Consolidated, KCB, and NBK; (ii) restructure the governance of Co-op to provide it with an independent and professional board of directors capable of adequately supervising management; and, (iii) amend Co-op’s statutes to permit it to access capital from sources outside the co-operative movement.

**Improving the Performance of NSSF**

6.23 Governance improvements and structural reforms are needed at the National Social Security Fund. By nearly every metric of pension fund performance, NSSF has performed badly. Past and current management has suffered from allegations of improper conduct and corruption. The recent World Bank study (World Bank 2007d) on pension reform includes several recommendations for reforming NSSF. Among the suggested reforms are: developing a more detailed governance framework for investment management; utilizing external investment managers; introducing stronger disclosure requirements and submitting to external reviews; being required to comply with the Retirement Benefits Authority (RBA) Act; and strengthening the management of NSSF itself. As of late 2006, NSSF has not been exempt from the RBA Act; however, NSSF has been very slow in complying with the RBA requirements and has resisted efforts to perform a diagnostic audit.

**Developing Investment Guidelines for Insurance Companies**

6.24 Establishing an autonomous insurance regulator with responsibility for setting investment guidelines will help ensure that insurance companies make prudent investments. Many of the larger life insurance companies have followed a relatively prudent portfolio allocation strategy, investing primarily in long-term government bonds. However, largely the sector has operated unregulated, with many small to medium-sized firms making riskier investments.

**Utilizing Guarantee Instruments**

6.25 The government and international financial institutions (IFIs) can facilitate private sector investment by providing guarantee instruments. The government can provide a partial risk guarantee (PRG) issued by the World Bank to lenders to the project sponsor in the event that the company defaults because of revenue shortfalls due to unscheduled changes in policy and/or regulation.

6.26 Furthermore, partial credit guarantees can help an enterprise raise a larger sum of funds and achieve a longer tenor than otherwise would have been possible had the firm relied solely on its own credit. Authorization from the central bank for the use of partial credit guarantees (PCGs), provided by the International Finance Corporation (IFC), will enable local banks to expand lending by overcoming exposure limits.

**DIASPORA BONDS**

6.27 Instead of borrowing money in the international capital markets or from foreign governments or multilateral financial institutions, some homeland governments have begun to turn to their diasporas for funding. Examples include India, Israel, the Philippines, Sri Lanka, and South Africa through is Reconciliation and Development Bonds. However, diaspora bonds are not yet widely used as an instrument of development finance. The diaspora purchases of bonds issued by their country of origin are likely to be driven by a sense of patriotism, and the desire to contribute to the development of the home country. The placement of bonds at a premium allows
the issuing country to leverage the charity element into a substantially larger flow of capital. To
the investors, diaspora bonds provide opportunity to diversify asset composition and improve risk
management.

6.28 There were about 427,000 people of Kenyan origin in high-income countries in 2005. Assuming
that members of the diaspora earn the average income of their host countries and save
a fifth of their income, the potential diaspora savings is about $US1.7 billion. There is scope for
tapping into these savings and diaspora bonds could potentially raise US$300 million to US$600
million annually for Kenya. Of course, raising funds through such bonds is likely to have an
impact on remittances, which have reached up to the level of 5 percent of GDP in the past. The
plus side of bonds is that while a large part of the remittances generally finances consumption,
diaspora bonds would finance investment directly. Box 6-2 discusses the experience of some
countries with diaspora bonds.

<table>
<thead>
<tr>
<th>Box 6-2: International Experience with Diaspora Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Israeli and Indian Experience</strong></td>
</tr>
<tr>
<td>The Jewish diaspora in the United States (and to lesser extent Canada) has supported development of Israel by buying bonds issued by the Development Corporation for Israel (offered by the fledgling state beginning in 1951). Currently, Israel uses proceeds from bond sales to finance major public sector projects such as desalination, construction of housing, and communication infrastructure. The Israeli government has adapted and expanded the range of instruments available to Jewish diaspora investors. New bond offerings have moved in recent years toward market pricing.</td>
</tr>
<tr>
<td>The Indian government has tapped its diaspora base of nonresident Indians (NRIs) for funding on three occasions (India Development Bonds after the balance of payments crisis in 1991; Resurgent India Bonds following the imposition of sanctions after nuclear testing in 1998; and India Millennium Deposits in 2000).</td>
</tr>
<tr>
<td><strong>Conditions and Candidates for Successful Diaspora Bond Issuance</strong></td>
</tr>
<tr>
<td>Factors that facilitate or constrain the issuance of diaspora bonds include having a sizeable diaspora abroad and a strong and transparent legal system for contract enforcement at home. Diaspora investors would require a minimum level of governability in their countries. The presence of national banks and other institutions in destination countries facilitates the marketing of bonds to the diaspora.</td>
</tr>
<tr>
<td>Countries also must follow the securities regime in the country where they plan to issue the diaspora bonds. If countries want to tap to the diaspora in the U.S. market, they will have to register their diaspora bonds with the U.S. Security and Exchange Commission. In Europe, the regulatory requirements are relatively less stringent than in the United States.</td>
</tr>
</tbody>
</table>

*Source: Ketkar and Ratha (2007); Ratha, Mohapatra, and Plaza (2007).*
APPENDIXES

A. BACKGROUND FIGURES AND TABLES

Figure A-1: Trend in Annual Percent Change in GDP Per Capita, 1960–2007

Table A-1: Output - Composition and Growth by Productive Sectors. Ten-Year Averages During 1960–2007

<table>
<thead>
<tr>
<th>Period</th>
<th>Composition of output by sector (percent of total)</th>
<th>Growth of output by sector (percent per year)</th>
<th>Contribution to growth of output by sector (percentage points)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Agriculture</td>
<td>Industry</td>
<td>Services</td>
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<tr>
<td>1960s</td>
<td>37.5</td>
<td>17.9</td>
<td>44.6</td>
</tr>
<tr>
<td>1970s</td>
<td>35.6</td>
<td>20.0</td>
<td>44.4</td>
</tr>
<tr>
<td>1980s</td>
<td>32.6</td>
<td>19.4</td>
<td>48.0</td>
</tr>
<tr>
<td>1990s</td>
<td>30.7</td>
<td>18.0</td>
<td>51.2</td>
</tr>
<tr>
<td>2000s</td>
<td>28.6</td>
<td>17.5</td>
<td>53.9</td>
</tr>
<tr>
<td>2003–7</td>
<td>27.1</td>
<td>17.9</td>
<td>55.0</td>
</tr>
</tbody>
</table>

Source: Staff calculations based on Economic Surveys, KNBS.

a: Obtained by multiplying the share of the sector in total output with the growth rate of the sector.

<table>
<thead>
<tr>
<th></th>
<th>Growth in output (percent a year)</th>
<th>Growth in output per worker (percent a year)</th>
<th>Physical capital per worker</th>
<th>Education per worker</th>
<th>Total Factor Productivity (TFP)</th>
<th>Physical capital per worker + TFP</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)=(2)-(3)-(4)</td>
<td>(6)=(3)+(5)</td>
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<td>China</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>1960–70</td>
<td>2.79</td>
<td>0.91</td>
<td>0.02</td>
<td>0.34</td>
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<td>0.43</td>
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<td>4.54</td>
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<td></td>
<td></td>
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<td>2.51</td>
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<td>0.54</td>
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<td>Education per worker</td>
<td>Total Factor Productivity (TFP)</td>
<td>Physical capital per worker +TFP</td>
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*Source: Data obtained from the authors of Bosworth and Collins (2003).*
Figure A-2: Kenya's Ranking in “Doing Business 2008”


Figure A-3: Global Competitiveness Index, Kenya: The Most Problematic Factors for Doing Business, 2007-8

Table A-3: Comparative Tax Rates for Residents in EAC Countries and Comparators

<table>
<thead>
<tr>
<th>Tax</th>
<th>Kenya</th>
<th>Uganda</th>
<th>Tanzania</th>
<th>Rwanda</th>
<th>South Africa</th>
<th>Mauritius</th>
<th>Burundi</th>
<th>Zambia</th>
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<tr>
<td>Corporate Tax rate (%) (PAYE)</td>
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<td>30</td>
<td>30</td>
<td>35</td>
<td>28</td>
<td>22.5</td>
<td>35</td>
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<td>Top Income Tax rate</td>
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<td>30</td>
<td>30</td>
<td>40</td>
<td>—</td>
<td>35</td>
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<tr>
<td>VAT rate</td>
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<td>18</td>
<td>20</td>
<td>18</td>
<td>14</td>
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<td>Excise on petrol (p)/diesel(d)</td>
<td>Ksh 19.8 per litre (p)/Ksh</td>
<td>Frw 116/litre (p)/Frw</td>
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<td></td>
<td></td>
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<td></td>
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<tr>
<td></td>
<td>10.3 per litre (d) Ush 530/d per litre</td>
<td>100/litre (d)</td>
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<td></td>
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<td></td>
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<tr>
<td></td>
<td>250/litre</td>
<td>—</td>
<td>—</td>
<td>70%</td>
<td>43%</td>
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Source: Kenyan authorities
## Table A-4: Share of Ten Largest Products in Kenya's Total Exports

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<th>Product code</th>
<th>Product name</th>
<th>Percent of total exports</th>
<th>Rank</th>
<th>Product code</th>
<th>Product name</th>
<th>Percent of total exports</th>
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<td>Tea and mate</td>
<td>20.3</td>
<td>1</td>
<td>334</td>
<td>Refined petroleum products</td>
<td>24.1</td>
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<tr>
<td>071</td>
<td>Coffee and coffee substitutes</td>
<td>15.1</td>
<td>2</td>
<td>074</td>
<td>Tea and mate</td>
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<tr>
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<td>Refined petroleum products</td>
<td>7.1</td>
<td>3</td>
<td>292</td>
<td>Crude vegetable materials</td>
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<td>292</td>
<td>Crude vegetable materials</td>
<td>5.8</td>
<td>4</td>
<td>054</td>
<td>Vegetable, fresh, frozen</td>
<td>5.8</td>
</tr>
<tr>
<td>674</td>
<td>Plates and sheets of iron</td>
<td>3.6</td>
<td>5</td>
<td>071</td>
<td>Coffee and coffee substitute</td>
<td>3.2</td>
</tr>
<tr>
<td>058</td>
<td>Fruit, preserved</td>
<td>3.4</td>
<td>6</td>
<td>058</td>
<td>Fruit, preserved</td>
<td>2.8</td>
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<tr>
<td>054</td>
<td>Vegetable, fresh, frozen</td>
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<td>7</td>
<td>892</td>
<td>Printed matter</td>
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<td>Soap, cleansing and polishing</td>
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<td>674</td>
<td>Plates and sheets of iron</td>
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<tr>
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<td>Lime, cement, fabricated construction materials</td>
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<td>10</td>
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<td>Fish, fresh</td>
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*Source: UNTRADE.*
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<th>Code</th>
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<th>Growth 2000/01</th>
<th>Share % 2000/01</th>
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<td>0.3</td>
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<td>61</td>
<td>Sugar &amp; honey</td>
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<td>0.3</td>
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<td>Cotton</td>
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<td>268</td>
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<td>933</td>
<td>Articles of wood &amp; related products</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>934</td>
<td>Baby carriages &amp; related products</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>971</td>
<td>Gold, non-monetary</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Source: Staff calculations.
<table>
<thead>
<tr>
<th>Project name</th>
<th>Sector</th>
<th>Financial closure</th>
<th>Total investment (capacity)</th>
<th>Type, subtype of PPI</th>
<th>Status</th>
<th>Contract period (terminal year)</th>
<th>Percent private equity</th>
<th>Contract award method (bid criteria)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Kenya Electricity Generating Company Limited</td>
<td>Energy</td>
<td>May-06</td>
<td>$109 million (945 MW)</td>
<td>Partial divestiture</td>
<td>Operational</td>
<td>n.a.</td>
<td>30</td>
<td>n.a.</td>
</tr>
<tr>
<td>7 Aggreko Embakassi and Eldoret Power Stations</td>
<td>Energy</td>
<td>Apr-06</td>
<td>$8 million (100 MW)</td>
<td>Greenfield Project (rental)</td>
<td>Operational</td>
<td>1 (2007)</td>
<td>100</td>
<td>Competitive bidding</td>
</tr>
<tr>
<td>11 Telkom Kenya Limited</td>
<td>Telecom</td>
<td>Nov-07</td>
<td>$369 million</td>
<td>Partial divestment and management control</td>
<td>Operational</td>
<td>n.a.</td>
<td>51</td>
<td>Competitive bidding</td>
</tr>
<tr>
<td>13 African Cargo Handling, Nairobi</td>
<td>Transport (airport terminal)</td>
<td>May-98</td>
<td>0</td>
<td>Management contract</td>
<td>Canceled</td>
<td>n.a.</td>
<td>100</td>
<td>n.a.</td>
</tr>
<tr>
<td>Project name</td>
<td>Sector</td>
<td>Financial closure</td>
<td>Total investment (capacity)</td>
<td>Type, subtype of PPI</td>
<td>Status</td>
<td>Contract period (terminal year)</td>
<td>Percent private equity</td>
<td>Contract award method (bid criteria)</td>
</tr>
<tr>
<td>--------------------------------------</td>
<td>-----------------------</td>
<td>-------------------</td>
<td>----------------------------</td>
<td>----------------------</td>
<td>---------------</td>
<td>---------------------------------</td>
<td>------------------------</td>
<td>-------------------------------------</td>
</tr>
<tr>
<td>Magadi Railway Company</td>
<td>Transport (railroads)</td>
<td>n.a.</td>
<td>n.a.</td>
<td>Concession</td>
<td>Operational</td>
<td>n.a.</td>
<td>100</td>
<td>n.a.</td>
</tr>
<tr>
<td>Kenya–Uganda Line</td>
<td>Transport (railroads)</td>
<td>n.a.</td>
<td>n.a.</td>
<td>Concession</td>
<td>Operational</td>
<td>n.a.</td>
<td>100</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

Source: World Bank, PPI database, updated by staff
n.a. not applicable
B. KENYA AGRICULTURE POLICY REVIEW—PRELIMINARY MESSAGES

Agriculture remains a critical sector in the Kenyan economy—for poverty reduction as well as for overall economic growth. It not only constitutes almost a quarter of the total GDP, but also accounts for half the manufacturing production. It contributes a disproportionately large share of total employment and exports. About 65 percent of Kenyan population is rural, and of these almost 60 percent live in poverty, relying directly or indirectly on agriculture for their livelihoods. Their wellbeing and overall economic growth depend on the performance of agriculture.

The key to better performance in agriculture is rapid increases in productivity, particularly in smallholder farming. This requires not only increases in physical production volumes and values (the supply side), but also better linkages of farmers to diversifying consumer markets (the demand side). In other words, the need is to not only encourage food crop productivity, which is critical for poverty reduction and promoting broader economic growth through lower real prices of food, but to also help small- and medium-size landholders to transform from subsistence-oriented agriculture to more commercial and higher-valued outputs. To bring about this transformation, the role of the state is central by investing in critical public goods and facilitating key institutions to promote better and more efficient markets and private sector participation. The analysis in the review identifies three areas of focus for the state’s efforts: responsive and efficient delivery of key agricultural services, upgrading and maintaining critical rural infrastructure, and supporting more efficient markets and private sector.

Some crosscutting policy recommendations relevant for the most agricultural subsectors are presented below. More detailed sub-sector specific recommendations for policy actions are summarized in the final concluding section of the review. While all of the below measures can contribute to increased agricultural growth, it is unlikely that any one will prove effective in isolation. Policy makers should, therefore, select strategic combinations of both investments and policy measures to achieve the desired outcomes.

1. Increasing public expenditure for the agriculture-related public goods. Public spending on agriculture in Kenya has fallen dramatically in real terms, having peaked in the late 1980s and declined substantially thereafter. Since 2000, total public spending on agriculture has not exceeded 5 percent of the total budget spending, and based on the GoK’s projections, its share will remain around 5 percent.

Sustained public expenditures in agricultural research, extension, irrigation, animal health and veterinary services, market information, grades and standards, capacity strengthening of public staff, and other public goods are indispensable for agricultural growth and increased competitiveness. Land constraints and decreasing farm size imply the need to develop (agricultural research) and disseminate (extension) the low-cost technologies that increase yield and value. A critical factor for more effective research and extension or advisory services, is to make them more accountable to the farmers and more dynamic and responsive to the changing market environment. Overdependence on rain results in volatile yields and high crop loss, calling for increased support to cost-efficient irrigation and more effective water management, where economically feasible. Increasing the farmers’ share in consumer price would require the public expenditure in grades and standards, while the wide dissemination of market information would

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102 This appendix is drawn from an ongoing “Kenya Agriculture Policy Review” (World Bank 2008a).
better integrate markets and link farmers to consumers. This is also crucial for introduction of commodity risk management instruments.

2. Improvement in rural infrastructure and market access is another top and cross-cutting priority for public expenditure. Productivity enhancement, diversification, adoption of inputs and market performance are all found to be significantly influenced by access and infrastructure costs. Over time, the performance of major markets for agricultural products and inputs has improved significantly, but the transport costs from farm gate to primary and secondary markets remain high. Thus, the challenge is to tackle the rural transport problem, which adds at least 16 percent to wholesale maize price in Nairobi, 37 percent to sugar costs, and 50 percent to imported fertilizer cost in western Kenya, and staggering 69 percent to coffee. Addressing inefficiencies and problems with Mombasa port related services is also an important area.

3. Providing stable policy environment and more transparent regulatory framework, with consistent shift to market facilitation. In order to bring benefits, the public spending requires of being complemented and supported by stable policy environment with clear and rule-based public operations. The liberalization has reduced market distortions and domestic prices have increasingly followed correspondent border prices. However, the GoK’s direct involvement in private sector activities and markets remains high and needs to be changed. The examples are the pan-seasonal buying and selling of maize by NCPB, the price support to sugarcane producers, the continued state ownership of the most sugar factories, Kenya Seeds Company (KSC)’s dominant position in seeds market, and the reintroduction of assets of Kenya Cooperative Creameries (KCC) dairy plants and Kenya Meat Company (KMC) processing facilities in disease-free zones, which all significantly diminish the economic value of the existing private investment in the agricultural sector and displace future investment.

The phenomenon of subsidized government intervention in the market, or the threat of it, leading to private sector inaction, is one of the greatest problems plaguing the food and input marketing systems in Kenya, and doubtlessly raises the costs of marketing, production, and coordination in the supply value chains. A more transparent and investor friendly regulatory framework is needed to encourage investment in the sector and related service sectors.

A more consultative framework for public-private sector dialogue is needed to move toward greater coordination and predictability in government behavior. Regular consultative meetings between public and private sector can build trust and communication that is needed to reduce market risks and promote long-term investments. Millers and traders would benefit from more transparent system of maize price setting by NCPB. Stakeholders in some industries such as dairy and livestock should have more opportunities to say in decision making over the use of cess and management of the boards.

4. Strengthening the performance of traditional marketing systems. The performance of “traditional” food systems will remain a much more important determinant of farmer welfare and consumer food security than supermarkets. Hence, focus investment priorities on improving the performance of traditional food marketing systems is crucial.

- Increasing public investment in upgrading the urban wholesale and retail market facilities to reduce the costs and risks to farmers and traders and to leverage private investments.
- Investing in development and enforcement of grades and standards and more easily available information on prices and volume by grade of product to increase market transparency and further attract customers.
- Increasing public investment in rural roads, market infrastructure, and storage facilities.
- Strengthen the focus of extension services in favor of smallholders to build the capacity for producer organizations that can bulk produce; access to market information; credit to enable groups to rent storage space and vehicle to transport produce themselves; and trade linkages through commodity exchange arrangements.

5. **Promoting regional trade.** While the increased competitiveness of export crops remains important task in the policy agenda, more gains should be extracted from regional trade in staple crops to foster broad-based agricultural growth and promote farm diversification. This trade has increasingly taken place in the region, through both formal and informal channels, and its expansion has the great potential to become a source of “quick wins” for reducing price volatility, expanding the size of the market (both input and output), increasing the elasticity of demand facing farmers, and consequently promoting food security at household level. Investing in market infrastructure, reducing trade restrictions and interventions, reducing nontariff barriers to trade, harmonizing quality, safety standards and phytosanitary requirements with neighbors, and streamlining customs procedures would all contribute to further regional trade.
C. A NOTE ON BANKING SECTOR EFFICIENCY AND FINANCIAL OUTREACH

Kenya's financial systems are well developed by regional standards, but they lack the depth and efficiency to deliver the desired growth. In 2006, the ratio of financial system deposits to GDP was 34.6 percent, while the ratio of bank deposits to GDP was 33.1 percent. These figures compare favorably with other African countries, where average bank deposits/GDP hover near 25 percent, but they remain however substantially below the averages for higher growth regions like East Asia Pacific (51.4 percent) and South Asia (46.3 percent). Private sector credit to GDP—a key indicator for intermediation efficiency—shows a similar profile, at 24.3 percent in 2006 for Kenya, exceeding the Africa region average, but significantly below the averages for East Asia Pacific (43.0 percent) and South Asia (38.3 percent) (Figure C-1).

Figure C-1: Financial Sector Depth and GDP Per Capita, 2000–5

![Graph showing financial sector depth and GDP per capita, 2000–5.](source)

The vast majority of deposits and assets in the financial system are housed in banks, and the government still maintains a sizable ownership stake in the sector. Though it is the most important component of the financial system, the banking sector continues to be heavily influenced by the state, with over a quarter of deposits and assets held by four state-influenced banks: KCB, Co-op, NBK, and Consolidated (Table (2-1). Recent loan growth has been concentrated in foreign and domestic private banks. Domestic privately owned banks grew most rapidly, sharply increasing their share of total loans as the shares of the state-influenced banks declined. Private domestic banks had the largest gains in the share of total assets and loans net of banks’ net loans, which had been built up because of decades of politically influenced and incompetent lending. Second, new lending by NBK and Consolidated was effectively frozen because of insolvency and

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103 World Bank financial structure database, October 2007 update.
104 The decline in the net loans of state banks was in large measure caused by two factors. First, state-influenced banks finally provisioning against the very large losses in their loan portfolios (reducing the banks’ net loans), which had been built up because of decades of politically influenced and incompetent lending. Second, new lending by NBK and Consolidated was effectively frozen because of insolvency and
of provisions, from 22 percent to 29 percent on both measures. Foreign banks experienced a
decline in asset share from 2003 to 2005 (from 49 percent to 43 percent), though a slighter
decline in net loan share (from 44 percent to 42 percent), which is a reflection of the relatively
high quality of their portfolios.

Table C-1: Growth and Structure of Kenya’s Banking Sector, 2000–5

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private credit/GDP</td>
<td>25.6</td>
<td>24.1</td>
<td>23.8</td>
<td>23.1</td>
<td>23.3</td>
<td>24.3</td>
</tr>
<tr>
<td>Loans (net of provisions)/GDP</td>
<td>20.8</td>
<td>20.2</td>
<td>21.3</td>
<td>21.0</td>
<td>22.9</td>
<td>22.9</td>
</tr>
<tr>
<td>Real GDP growth</td>
<td>0.6</td>
<td>3.8</td>
<td>0.6</td>
<td>3.0</td>
<td>4.9</td>
<td>5.8</td>
</tr>
</tbody>
</table>

**Share of banking sector assets**

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign</td>
<td>44.3</td>
<td>46.3</td>
<td>48.3</td>
<td>48.7</td>
<td>45.3</td>
<td>43.4</td>
</tr>
<tr>
<td>Private domestic</td>
<td>21.9</td>
<td>22.7</td>
<td>22.6</td>
<td>24.1</td>
<td>25.7</td>
<td>28.7</td>
</tr>
<tr>
<td>Government</td>
<td>7.1</td>
<td>7.1</td>
<td>6.6</td>
<td>6.0</td>
<td>6.2</td>
<td>5.6</td>
</tr>
<tr>
<td>NBK</td>
<td>6.1</td>
<td>5.9</td>
<td>5.7</td>
<td>5.2</td>
<td>5.5</td>
<td>5.2</td>
</tr>
<tr>
<td>Government-influenced</td>
<td>26.7</td>
<td>23.9</td>
<td>22.5</td>
<td>21.2</td>
<td>22.7</td>
<td>22.2</td>
</tr>
<tr>
<td>KCB</td>
<td>16.6</td>
<td>15.0</td>
<td>12.8</td>
<td>11.7</td>
<td>11.9</td>
<td>11.8</td>
</tr>
<tr>
<td>Cooperative</td>
<td>5.7</td>
<td>5.2</td>
<td>6.5</td>
<td>6.5</td>
<td>8.3</td>
<td>8.2</td>
</tr>
</tbody>
</table>

**Share of total loans (net of provisions)**

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign</td>
<td>39.9</td>
<td>40.8</td>
<td>41.9</td>
<td>43.7</td>
<td>42.5</td>
<td>42.3</td>
</tr>
<tr>
<td>Private domestic</td>
<td>22.1</td>
<td>22.0</td>
<td>22.6</td>
<td>24.4</td>
<td>25.4</td>
<td>28.8</td>
</tr>
<tr>
<td>Government</td>
<td>10.0</td>
<td>9.8</td>
<td>10.0</td>
<td>9.7</td>
<td>8.4</td>
<td>7.7</td>
</tr>
<tr>
<td>NBK</td>
<td>9.2</td>
<td>8.9</td>
<td>9.0</td>
<td>8.7</td>
<td>7.6</td>
<td>7.3</td>
</tr>
<tr>
<td>Government-influenced</td>
<td>28.0</td>
<td>27.4</td>
<td>25.5</td>
<td>22.3</td>
<td>23.6</td>
<td>21.3</td>
</tr>
<tr>
<td>KCB</td>
<td>16.5</td>
<td>15.8</td>
<td>12.8</td>
<td>10.7</td>
<td>11.3</td>
<td>9.9</td>
</tr>
<tr>
<td>Coop</td>
<td>5.8</td>
<td>6.3</td>
<td>8.3</td>
<td>7.7</td>
<td>9.2</td>
<td>8.7</td>
</tr>
</tbody>
</table>

*Source:* Data for private credit/GDP are from the World Bank financial structure database. Data for real GDP growth and nominal GDP are from World Development Indicators. Data for all other calculations are from the Central Bank of Kenya.

Recent declines in interest rate spreads indicate that banks have become more efficient, resulting in more affordable interest rates for borrowers. Private domestic and foreign banks were responsible for those improvements, while enhanced efficiency and governance of state-owned banks could provide further gains. Mirroring the Investment Climate Assessment results described in the body of the report, which showed that firm owners are less apt to cite the availability and costs of finance as a severe obstacle to doing business in 2007 than they were in 2003, the difference between lending and deposit rates has declined (figure C-2). Regression analysis of the determinants of Kenyan spreads strongly indicates that the decline was attributable to reductions in overhead costs and improvements in portfolio quality on the part of private banks. High overhead costs and poor portfolio quality at state banks represent a large opportunity cost, as the deposits and other liabilities of those banks could be intermediated at lower costs and channeled to investments that are more productive.

illiquidity—problems that the government failed to address by implementing a comprehensive scheme for restructuring and privatizing both banks.

105 See background report, “Financial Sector Efficiency and Outreach in Kenya.”
Reductions in interest spreads coincided with a shift from holding government securities and lending to manufacturing toward consumer lending, but only for foreign and private domestic banks, including consumer-focused new entrants such as Equity Bank. The sharp decline in spreads since 2003 owes much to improvements in Kenya’s fiscal situation and general macroeconomic management, which led in turn to increasing competition among banks as a result of substantial declines in both the volume of government securities issued and the interest rates paid. As government securities became a less attractive investment option for banks, they were forced to seek lending opportunities, and the competition between banks for those lending opportunities coincided with lower spreads.

Private and state banks did not respond to these pressures in the same way. Private domestic banks roughly doubled their holdings of government securities from 2000 to 2003 as the supply of these instruments increased. Foreign banks maintained much higher shares than other banks throughout the period, reaching their highest average share in 2003 (50 percent of earning assets). Subsequently, both groups of banks shifted out of these holdings as the issuance of government securities fell as a percentage of GDP after 2003 (Figure C-3). By contrast, government banks decreased their holdings of government securities when the supply and yield on these instruments were highest (from 2000 to 2002), and then increased their holdings as the supply and yield decreased (from 2003 on). This pattern provides another indication that government banks were not responsible for the reduction in interest rate spread.
Since 2003, in addition to improved macroeconomic management, the government also made some efforts to restructure and provide new incentives and management for banks in which the government retained an ownership stake: KCB received a capital injection in 2004 by means of a rights issue combined with resolution of certain state-guaranteed nonperforming loans. Industrial Development Bank was delicensed in 2005. Efforts were also made to restructure Co-operative Bank. The government provided some financial support to the bank, although the bank’s ownership structure—dispersed across the savings co-operative movement—weakens its ability both to strengthen its governance and its potential for serving its target client base in the rural communities by limiting its ability to raise capital to the resources available from within the co-operative movement. Lastly, the CBK intervened to restrict NBK’s lending and forced it to adopt an internal restructuring program while its liquidity was at least partially restored by means of government purchases of nonperforming loans.

Despite the above-described positive steps taken toward improving the condition of the state influenced banks, critical steps were not taken to complete the restructuring process. In KCB’s case, the government did not take advantage of positive market conditions to dispose of its remaining 26 percent stake in the bank, and as a result retains effective control, posing the threat that KCB could be subject to political abuse in the future as it was in the past. In NBK’s case, the government (in 2007) proceeded to recapitalize the bank without first taking steps to transform its governance and thus leaving it also exposed to abuse. Lastly, no action was taken to dispose of the state’s stake in Consolidated, which continues to be financially weak.

Access to Financial Services

In 2006, the Financial Sector Development Trust Kenya completed the Financial Access Survey (FAS) which provides an up-to-date and comprehensive survey of access to financial services in Kenya. The FAS confirms four previously-assumed conclusions about access to financial services: (a) a large proportion of the Kenyan population has no access to financial services, whether formal or informal; (b) there is a general tendency for access to a given service to decline as one goes from urban, to rural, to semi-arid and then arid districts; (c) the percentage of the population that uses no financial services is much higher in arid districts than in others; and (d)
although the percentage of the population that is served is similar in urban, rural, and semi-arid districts, the mix of those services is different. In urban areas, respondents rely more heavily on services from banks and semi-formal sources (SACCOs and MFIs) while in rural and semi-arid districts, there is greater reliance on services provided via informal groups.

The FAS data reveals that the costs of an account and the qualifications necessary to obtain one are the second and third most popular reasons for being unbanked (table C-2). Roughly one-quarter to half of the respondents mentioned costs or qualifications as being relevant, which suggests that there are supply side constraints that impede access. Cross-country evidence for leading banks confirms that minimum balances, annual account fees, and the number of documents required to obtain an account are high by developing country standards. Wireless delivery mechanisms for basic payments and savings services could help consumers avoid these costs, and put competitive pressure on banks. If unbanked current cell phone users availed themselves of these services, the level of formal financial inclusion in Kenya would increase from its current 19 percent to almost 33 percent of adult Kenyans. While regulating these new providers and protecting their depositors would pose challenges, the potential for increasing the supply of available savings and thus boosting GDP growth rates would appear to be substantial.

Table C-2: Reasons Why Respondents Are Not Banked, By District Type

<table>
<thead>
<tr>
<th>Reason</th>
<th>Urban</th>
<th>Rural other</th>
<th>Semi-arid</th>
<th>Arid</th>
</tr>
</thead>
<tbody>
<tr>
<td>No/Inadequate income</td>
<td>100.0</td>
<td>99.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Top: No money to save</td>
<td>57.1</td>
<td>56.7</td>
<td>58.5</td>
<td>69.0</td>
</tr>
<tr>
<td>Costs of account too high</td>
<td>61.6</td>
<td>43.1</td>
<td>48.6</td>
<td>40.7</td>
</tr>
<tr>
<td>Top: Cannot afford account</td>
<td>29.8</td>
<td>22.0</td>
<td>23.0</td>
<td>19.9</td>
</tr>
<tr>
<td>Prefer other options</td>
<td>30.1</td>
<td>15.4</td>
<td>22.4</td>
<td>17.8</td>
</tr>
<tr>
<td>Top: Prefer dealing in cash</td>
<td>14.5</td>
<td>5.9</td>
<td>11.5</td>
<td>9.7</td>
</tr>
<tr>
<td>Lack of qualifications</td>
<td>30.1</td>
<td>26.5</td>
<td>36.7</td>
<td>24.9</td>
</tr>
<tr>
<td>Top: You do not have a job</td>
<td>20.1</td>
<td>16.3</td>
<td>21.0</td>
<td>11.8</td>
</tr>
<tr>
<td>Negative perceptions of banks</td>
<td>5.2</td>
<td>1.3</td>
<td>2.4</td>
<td>2.6</td>
</tr>
<tr>
<td>Top: Don’t trust banks</td>
<td>4.2</td>
<td>0.9</td>
<td>2.4</td>
<td>2.6</td>
</tr>
<tr>
<td>Inconvenience</td>
<td>4.8</td>
<td>4.0</td>
<td>9.9</td>
<td>9.2</td>
</tr>
<tr>
<td>Top: Bank is too far away</td>
<td>3.1</td>
<td>2.8</td>
<td>8.3</td>
<td>8.1</td>
</tr>
<tr>
<td>Other</td>
<td>6.6</td>
<td>2.7</td>
<td>2.2</td>
<td>2.4</td>
</tr>
</tbody>
</table>

**Source:** Staff calculations based on Financial Access Survey 2006, Financial Sector Development Trust, Kenya.

**Note:** Sample size = 3,493.

The table reports the total number of reasons that respondents checked in the survey divided by the number of respondents in a given category. Because multiple reasons could be checked, the number of affirmative responses can

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107 The data are taken from the 2006 Financial Access Survey undertaken by the Financial Sector Development Trust Kenya.

108 See background report, “Financial Sector Efficiency and Outreach in Kenya.” The data on the costs and procedures for providing financial services for the leading banks in developing countries are from Beck, Demirguc-Kunt, and Martinez Peria (2007).
Access to Credit

A large proportion of the Kenyan population—regardless of where they live—has no access to any type of financial services. However, when access to credit is considered, the picture is even bleaker. Only wage earners have any significant (and still extremely limited) access to formal sources of credit and although there is evidence of declining access to credit as one goes from urban to arid areas, it is the low levels of credit for any district type that is most significant. The data are thus consistent with the notion that formal providers of credit find it easier to deal with individuals that earn a regular wage, and this appears to be because wage earners are seen as posing fewer risks, are more aware of opportunities to obtain credit, or are somehow better targeted by banks. Together, the data indicates that even for the proportion of the population that does have access to financial services in some form, these services are limited to savings and payments products.

The Effect of Bank Branching on Access to Finance

Over 90 percent of the Kenya’s branches are in urban and rural districts (Figure C-4). Branches in semi-arid districts account for 4.7 percent of the national total; those in arid districts account for 2.8 percent. Even if the definition of branch is expanded to include all types of access points—agencies, pay-points, mobile units, satellite branches, and sub-branches—this picture is essentially unchanged (93 percent in urban and rural areas, 7 percent in arid and semi-arid areas). The distribution of also reflects a difference in geographical emphasis between private and government-owned or influenced banks.
The government and government-influenced banks represent about a fifth of total branches in urban districts, over half in rural districts, three-quarters in semi-arid districts, and almost ninety percent in arid districts. This suggests that government influence has a positive impact in promoting access to financial services but, in the absence of an analysis to assess the costs of government-influenced banks' poor lending practices, it should not be concluded that government ownership is either the best or the cheapest way in which to maintain rural access to the banking system. A detailed analysis is likely to show that a more effective—and cheaper—approach may be to provide subsidies to private sector banks to increase their rural presence using lower-cost mechanisms (such as mobile offices and new technologies such as mobile payments) and reinforce this by promoting the development and regulation of nonbanking institutions such as SACCOs and MFIs.

The important role of the top 10 banks (ranked by assets) in providing access to banking services is also clearly reflected in Figure C-4. A member of the Top 10 is the main bank for 75 percent of the banked respondents in urban areas, 67 percent in rural and semi-arid areas, and 55 percent in arid areas. The PostBank provides most of the remaining access, playing an increasingly important role as one goes from urban to arid districts. Non-Top 10 banks play a much more marginal role, and then only in urban and rural districts. Although the branching figures indicate that non-top 10 banks account for 45 percent of urban branches and 35 percent of rural branches, those branches provide services to far fewer people than do the branches of the Top 10 banks.

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109 Five branches owned by private domestic banks were not identified as belonging to a district type. In parentheses are the shares of total points of presence pertaining to each bank type/district type pair.

110 Foreign banks in the Top 10 include Barclays, Standard Chartered, and Stanbic. The domestic banks in the Top 10 are Equity, KREP, Baroda, and Commercial Bank of Africa. Cooperative, KCB, and NBK are the government-owned banks that round out the Top 10.
D. INTEREST RATES AND COUNTRY RISK PREMIUM

In 2006, S&P rated Kenya's capacity to repay long-term sovereign obligations denominated in foreign currency as B+, which indicates that the sovereign has the capacity to meet its financial commitment, but adverse business, financial, or economic conditions could impair its capacity. Kenya's external debt is mainly on concessional terms and it has not had access to international capital markets; hence, a time series on external market borrowing costs is not available. However, the S&P rating implies that its obligations today would be substantially below investment grade. Countries that received the same S&P rating of B+ in 2006 and are tracked by the EMBI+ index exhibited a spread of over 200 basis points (bps) at end-2006 over U.S. Treasuries, about 50 bps above the overall EMBI+ spread at end-2006.

What can be inferred about sovereign risk from Kenya's domestic borrowing costs? Figure D-1 shows the annualized yield on Kenya's 91-day T-bill rate. There is a clear declining trend after the spike associated with the Goldenberg scandal, with interest rates continuing to fall and going below 10 percent starting in 2002, with lows in 2003 and 2004. Since Kenya has no exchange controls, the following formal construct can help shed light on risks:

\[ i_K = i_T^* + \hat{x} + DRP + SRP, \]

where \( i_K \) is the nominal interest rate on Kenyan government T-bills (denominated in Kenyan shillings), \( i_T^* \) is the nominal interest rate on U.S. government T-bills (denominated in U.S. dollars), and \( \hat{x} \) is the target devaluation rate for the K Sh/US$ exchange rate. This is standard interest parity. Risk could arise on two counts. Suppose the market believes the eventual depreciation rate will turn out higher than that (explicitly or implicitly) targeted by the CBK. It will then demand a devaluation risk premium, DRP, to compensate for this. Suppose it also believes—given Kenya's image of political instability and weak governance—that the government could default on its debt. It would then demand a sovereign or default risk premium, SRP, to compensate for this. The SRP could be regarded as a function of Kenya's credit and inflation history, its political risk and the quality of its fiscal and financial institutions.
Figure D-1: Kenya 91-day T-bill Rate, 1991–2006

Table D-1 presents data organized around the preceding equation. It shows that Kenyan T-bill rates have fallen along with U.S. T-bill rates, suggesting that the favorable global interest rate climate has filtered through to Kenya; this is particularly evident in 2003 and 2004. In addition, changes in monetary policy may have contributed to the very low interest rates in 2003 and 2004. The cash reserve ratio was lowered from 10 percent (on 14-day average) and 8 percent daily average in October 2000 to and 6 percent daily in July 2003. Some of these moves coincided with the maturing of a large tranche of repo operations, boosting short-run liquidity and lowering domestic interest rates. Of course, since Kenya has an open capital account, this money could leave and be invested in U.S. or UK T-bills; this would put upward pressure on interest rates on Kenyan T-bills. Alternatively, banks and other investors may be hampered from investing overseas because of prudential restrictions; however, there is little evidence that such restrictions are binding. Investors have the option of investing in capital market or real estate if returns on T-bills are considered too low, but capital markets are not well developed and they themselves have been showing signs of asset overpricing. One additional factor may be contributing to low interest rates: Kenya as a regional safe haven for financial assets. Such investors are not likely to be fussy about the rate of return.

Table D-1: Interest Rate Decomposition, 1991–2006

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>91-day Kenya T-bill rate</td>
<td>13.3</td>
<td>12.1</td>
<td>12.7</td>
<td>8.9</td>
<td>3.7</td>
<td>3</td>
<td>8.4</td>
<td>7.4</td>
</tr>
<tr>
<td>U.S T-bill rate</td>
<td>4.7</td>
<td>5.8</td>
<td>3.5</td>
<td>1.6</td>
<td>1</td>
<td>1.4</td>
<td>3.2</td>
<td>4.6</td>
</tr>
<tr>
<td>Difference</td>
<td>8.6</td>
<td>6.2</td>
<td>9.2</td>
<td>7.3</td>
<td>2.7</td>
<td>1.8</td>
<td>5.3</td>
<td>2.9</td>
</tr>
<tr>
<td>Actual KSh./US$ depreciation (end of period)</td>
<td>17.8</td>
<td>7</td>
<td>0.7</td>
<td>-1.9</td>
<td>-1.2</td>
<td>1.8</td>
<td>-6.4</td>
<td>2.1</td>
</tr>
<tr>
<td>EMBI/Africa (in basis points)</td>
<td>529</td>
<td>313.6</td>
<td>216.7</td>
<td>161.8</td>
<td>123.8</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nigeria</td>
<td>1338</td>
<td>2037</td>
<td>1426</td>
<td>2276</td>
<td>732</td>
<td>667</td>
<td>523</td>
<td>481</td>
</tr>
<tr>
<td>South Africa</td>
<td>238</td>
<td>141</td>
<td>95</td>
<td>85</td>
<td>81</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EMBI+spread (in basis points)</td>
<td>824</td>
<td>756</td>
<td>731</td>
<td>765</td>
<td>418</td>
<td>356</td>
<td>245</td>
<td>169</td>
</tr>
</tbody>
</table>

Source: Central Bank of Kenya; International Financial Statistics; JP Morgan; and staff estimates
E. GROWTH SIMULATIONS

The development policies of the Government of Kenya are driven by the objective of achieving Vision 2030, under which the key objective is to accelerate GDP growth to an annual rate of 10 percent. This is a very ambitious objective considering that, during the last 25 years, annual real GDP growth was merely 3 percent.

This appendix explores what steps may be required for Kenya to achieve this objective. The work takes a macro perspective and is meant to complement sector- and micro-oriented policy analysis. Methodologically, it combines simulations of alternative scenarios for Kenya’s economy for the 2006–30 period with a discussion of the implications of the results for policy makers. The simulations rely on a macro-oriented Kenyan version of MAMS (Maquette for MDG Simulations), a tool developed at the World Bank for analysis of development strategies.

The simulations investigate the potential roles of likely driving forces behind the required growth acceleration. More specifically, the simulations first introduce, one by one, increases in national savings, foreign direct investment (FDI), and foreign aid. Subsequently, the analysis simulates the effect of combining changes in these growth determinants with increases in TFP (total factor productivity) growth. The advantage of using a model like MAMS for this type of analysis is that it, in a consistent and comprehensive manner, simulates the combined impact of these changes on major economic indicators including GDP, trade, private and government consumption, and investment, considering the presence of constraints at the macro level (represented by fiscal, foreign exchange, and savings-investment balances) and in factor markets and using standard assumptions about the behavior of producers, consumers, and government. Results of the simulations are summarized in Table E-1 and Table E-2.

Under the BASE scenario, which is a business-as-usual scenario that extrapolates on the recent pick-up in economic performance, GDP and most other aggregate indicators grow at around 5 percent per year, out of which 3.9 percent is due to increased factor employment and 1.1 percent is due to increased TFP. There are no major changes in the GDP shares of the national account aggregates or of major spending and receipt items in the government budget and the balance of payments.

High national savings rates are needed to sustain rapid GDP growth and high investment rates. The scenario BASE+GNS is identical to BASE except for a 50 percent increase in the gross national savings (GNS) rate from 2007 to 2017, from 15.7 percent to 23.5 percent, through an increase in private savings rates. After 2017, the GNS rate stays at 23.5 percent. For the 2007–30 period, this change leads to a strong increase in private investment, increasing growth in GDP by 1.6 percent, with a particularly strong increase for private investment. Due to the savings increase, private consumption growth initially slows down compared to other scenarios.

FDI may increase (and decrease) more rapidly than more slow-moving domestic financing sources and may lead to more rapid technological progress than investment by domestic firms. Under the scenario BASE+FDI, FDI gradually increases from a very low level in 2006 to 4 percent of GDP in 2017, a GDP share that is retained, with a slight decline, up to 2030. The scenario does not consider possible direct technological gains from FDI. The simulated effects are quite similar to those of the simulated GNS increase (but roughly half as large, given the smaller magnitude of the shock): a strong increase in private investment growth is coupled with a smaller
growth increase for GDP and other national account aggregates. Initially, private consumption and welfare fares better since there is no need to switch private income to savings. However, over time, growth in profit repatriation forces more export growth while reducing import growth (given balance of payments constraints a lower trade deficit is required), dampening the long-run positive impact on absorption (private and government consumption and investment) and welfare.

Foreign aid relaxes the budget constraint of the government, permitting increases in domestic consumption and investment. Under the scenario BASE+AID, aid (the part represented by current transfers from the rest of the world to the government) is increased gradually from a low level to around 4 percent of GDP in 2017: that is, a magnitude that is similar to the FDI level under BASE+FDI. It is kept close to this share up to 2030. The extra aid is used to reduce taxes. Government spending will increase in so far as GDP grows more rapidly. Households allocate their additional incomes to savings that feed into domestic private investment. The growth effects are very similar to those of BASE+FDI, but the welfare effects are more positive since grant aid does not lead to any resource outflow corresponding to profit repatriation. It also avoids the initial dampening of private consumption growth that is required under BASE+GNS.

The preceding scenarios have relaxed domestic resource constraints, permitting more savings, investments, and growth. However, they have only had smaller, indirect effects on TFP growth, the acceleration of which has to be at the core of Kenya’s Vision 2030 strategy. More rapid TFP growth would be likely in the context of rapid increases in investment (including FDI) and private savings, supported by increased aid. Hence, the scenario V30-GRADUAL combines the changes in the preceding scenarios (in GNS, FDI, and aid) with an increase in TFP growth sufficient to gradually raise GDP growth to 10 percent by 2017, a rate that is maintained up to 2030. The results indicate that this growth acceleration requires annual TFP growth at 2.6 percent, a rate that is far in excess of Kenya’s recent record (but actually slightly below the rate achieved during the first 13 years of independence) (Ndulu and others 2007, table 3.1, p. 61). Under this scenario, the growth rates for the full period 2006-30 are around 9 percent for GDP, 12 percent for private investment, and 8 to 11 percent for other national account aggregates. In 2030, private consumption per capita is 270 percent higher than in 2006: that is, not far from tripled.

The final scenario, V30-FAST, is similar to V30-GRADUAL except that the changes now are introduced more quickly, during the period 2007-13, after which GDP growth stays at 10 percent. Annual growth in TFP and most national account aggregates increase by an additional 0.2–0.5 percent (compared to V30-GRADUAL). In the final year, private per capita consumption is 310 percent above the level in 2006.

In terms of policy, what can be done to bring about such scenarios or, more broadly, to drastically accelerate growth in Kenya? Accumulated evidence suggests that the factors that may initiate the strived-for acceleration are increases in investment, including FDI accompanied by technological improvements. In the short to medium run, it is possible to improve governance and infrastructure, giving a needed boost to the investment climate and raising TFP (especially via

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111 The relative magnitudes of the shocks reflect what was considered plausible. Cross-country data indicate that the bulk of investment is typically financed from domestic sources. For high-investment countries, it is rare that foreign savings (out of which FDI is a part) finances more then 20 percent of investment (Rodrik 2000).

112 The underlying assumption is that decisions about private vs. government shares in the economy do not depend on the size of foreign aid. However, if GDP growth increases or decreases, then government consumption and investment will also increase/decrease sufficiently to maintain unchanged GDP shares.
reduced transactions costs). In the long run, human capital improvements are an essential ingredient of a good investment climate supportive of rapid TFP growth. Increases in private savings rates are more likely to follow than lead, given that they respond to income growth and changes in per capita income levels and dependency ratios that change more slowly. Further improvements in Kenya's financial sector may provide better incentives to savers and more efficiently channel their funds to private investors. Kenya can do less to influence aid inflows, especially in grant form. However, aid can play a critical role, especially in the beginning of the growth acceleration. Improvements in governance and the investment climate, combined with initial signs of success, should convince donors that additional aid would be put to good use, with long-lasting positive effects on welfare and poverty reduction.

| Table E-1: Real Macro Indicators by Simulation (% annual growth from 2006-2030) |
|-------------------------|-----------------|----------------|-----------------|----------------|
|                         | base| base+gs| base+fdl| base+aid| v30-gradual| v30-fast|
| Absorption              | 5.0 | 6.5   | 5.4   | 5.7   | 8.8   | 9.2   |
| Consumption-private     | 4.8 | 6.0   | 5.0   | 5.5   | 8.1   | 8.5   |
| Consumption-private per capita | 2.5 | 3.6   | 2.6   | 3.1   | 5.6   | 6.0   |
| Consumption-government  | 5.4 | 6.4   | 5.9   | 5.8   | 7.6   | 7.8   |
| Fixed investment-private| 4.6 | 8.3   | 5.9   | 5.9   | 11.8  | 12.3  |
| Fixed investment-government | 6.5 | 8.0   | 7.2   | 7.2   | 10.5  | 10.8  |
| Exports                 | 5.0 | 7.5   | 6.5   | 5.5   | 10.6  | 11.1  |
| Imports                 | 5.0 | 7.0   | 5.6   | 5.8   | 9.7   | 10.2  |
| GDP at market prices     | 5.0 | 6.6   | 5.6   | 5.6   | 9.0   | 9.4   |
| GDP at factor cost       | 5.0 | 6.6   | 5.6   | 5.6   | 8.9   | 9.4   |
| Total factor employment  | 3.9 | 5.3   | 4.5   | 4.4   | 6.4   | 6.6   |
| Total factor productivity (TFP) | 1.1 | 1.3   | 1.2   | 1.1   | 2.6   | 2.7   |
| ICORa                   | 3.8 | 4.0   | 3.8   | 3.8   | 3.3   | 3.3   |
| Real exchange rate       | -0.1| 0.0   | 0.2   | -0.2  | -0.4  | -0.4  |

Source: Staff calculations.

Table E-2: Macro Indicators in 2006 and by Simulation in 2030 (% of nominal GDP)

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2006</th>
<th>Final year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>base</td>
<td>base+g</td>
</tr>
<tr>
<td>Absorption</td>
<td>108.4</td>
<td>108.2</td>
</tr>
<tr>
<td>Consumption - private</td>
<td>73.9</td>
<td>72.1</td>
</tr>
<tr>
<td>Consumption - government</td>
<td>16.3</td>
<td>17.2</td>
</tr>
<tr>
<td>Investment - private</td>
<td>14.1</td>
<td>13.0</td>
</tr>
<tr>
<td>Investment - government</td>
<td>4.1</td>
<td>5.8</td>
</tr>
<tr>
<td>Exports</td>
<td>29.1</td>
<td>29.2</td>
</tr>
<tr>
<td>Imports</td>
<td>-37.5</td>
<td>-37.3</td>
</tr>
<tr>
<td>GDP at market prices</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Net indirect taxes</td>
<td>9.6</td>
<td>9.8</td>
</tr>
<tr>
<td>GDP at factor cost</td>
<td>90.4</td>
<td>90.2</td>
</tr>
<tr>
<td>Foreign savings</td>
<td>2.5</td>
<td>2.3</td>
</tr>
<tr>
<td>Gross national savings (GNS)*</td>
<td>15.7</td>
<td>16.5</td>
</tr>
<tr>
<td>Private savings</td>
<td>14.3</td>
<td>14.0</td>
</tr>
<tr>
<td>Government savings</td>
<td>1.4</td>
<td>2.5</td>
</tr>
<tr>
<td>Gross domestic savings (GDS)*</td>
<td>9.8</td>
<td>10.6</td>
</tr>
<tr>
<td>Foreign government debt</td>
<td>23.1</td>
<td>23.8</td>
</tr>
<tr>
<td>Domestic government debt</td>
<td>19.9</td>
<td>20.2</td>
</tr>
</tbody>
</table>

Source: Staff calculations.

a. GDS = GNS - [Net current transfers from Rest of the World to gov't and non-gov't] + [Net factor income to Rest of the World] + [Net interest income to Rest of the World].
For each of the sectors, product groups/products that have potential to expand exports immediately or in the medium term are identified. Binding constraints or threats holding export expansion were also identified as well as the responsive actions.

**Livestock and Livestock Products**
- Pork, poultry, red meat, raw hides and skins, "wet blue" skins, leather and leather products are identified for export expansion.
- The factors holding exports of these products include high costs, high disease preference, lack of internationally acceptable slaughterhouses, and poor quality hides and skins.
- The key activities to be undertaken include:
  - Streamlining the Tax Remission for Export Office (TREO)
  - Supporting investments in slaughterhouses
  - Monitor the development of Disease Free Zones
  - Lobbying for removal of unilateral export barriers imposed by regional trading partners in the East African Community (EAC) and Common Market for Eastern and Southern Africa (COMESA)
  - Training farmers and tanners on quality chain management

**Fish and Fish Products**
- Exports of fish fillet (frozen), fish fillet (fresh or chilled), and live fish will be emphasized.
- Factors affecting export expansion include; post harvest losses, lack of equipment for value addition, unexploited resources, and sustainability of Lake Victoria.
- The key activities that are identified for implementation are to:
  - Train fishermen in fishing and handling techniques
  - Develop landing beaches along the shores of Lake Victoria
  - Negotiate fish agreement for landing marine fish in Kenya
  - Conduct study on fishing sustainability at Lake Victoria
  - Carry out study to facilitate exploitation of Lake Turkana

**Textiles and Clothing**
- The immediate export flow will continue to be garments to USA.
- The future of the sector is threatened by high production costs, low productivity, and expiry of the Agreement on Textile and Clothing (ATC) in 2005 and third-country sourcing of fabrics in 2007.
- The key activities recommended here are to:
  - Negotiate with workers, unions, Ministry of Labor and Human Resources Development (MoLHRD) on modalities to reduce wages
  - Negotiate with Kenya Power and Lighting Company (KPLC) to reduce power tariffs
  - Allow containers be opened at factory under Kenya Revenue Authority (KRA) supervision
  - Establish export credit guarantee scheme based on confirmed orders
**Horticulture**

- Cut flowers, vegetables, and avocados will be the main export products for immediate and medium term expansion.
- The issues of concern to the sector are to increase sector competitiveness through cost reduction and value addition.
- The key activities that are envisaged include:
  - Re-establishing Value Added Tax (VAT) refunds
  - Eliminating unnecessary taxes and levies
  - Rehabilitate roads in growing areas
  - Improving capacity at Kenya Plant Health Inspectorate Service (KEPHIS)

**Food and Beverages**

- The products identified for export expansion are edible oils, alcoholic beverages, and dairy products.
- The constraints affecting expansion include duties, non-compliance with COMESA Rules of Origin, delays at Customs, and infrastructure.
- The key activities for implementation in this sector include:
  - Pressing Common Market for Eastern and Southern Africa (COMESA) partners to apply import rules as per the agreement of the Rules of Origin
  - Northern Corridor road to be upgraded
  - Improving capacity at Kenya Bureau of Standards (KEBS)
G. TOURISM

Tourism is Kenya's main service export. Tourism receipts in 2006 were estimated at K Sh 56 billion. There is a consensus view that tourism receipts have a significant potential to grow. This view is partly supported by the fact that Kenya's tourism industry has grown well below average compared to other countries in Sub-Saharan Africa. Vision 2030's target is for Kenya "to become a top ten long-haul destinations offering a high-end, diverse, and distinctive visitor experience."

Vision 2030's focus is on new investments to bring about rapid growth of tourism. Apart from growth, National Tourism Policy of 2006 lays down several other goals, such as safeguarding the sustainable conservation of Kenya's beaches, wildlife, and culture, and sharing benefits with local communities. The discussion that follows outlines key priorities for policy and institutional reform to complement targeted public and private investments proposed by the Vision. These priorities are stated in general terms at this stage and will be made specific as the ongoing analytic work on tourism in Kenya is completed (World Bank 2008b).

Priorities for policy and institutional reform

There is a need to improve coordination between several ministries (about seven) and public agencies involved in tourism-related activities. The main ones are Kenya Wildlife Service (KWS), Kenya Tourism Board (KTB), and National Environmental Management Authority (NEMA). In addition, County Councils play a role in some areas such as Masai Mara. Regional development authorities such as the Coast Development Authority also have overlapping mandates. Policy and institutional reform would have the following objectives:

- Developing coordination mechanisms among accountable ministries and public agencies.
- Harmonizing mandates. Legal and regulatory framework may need to be adjusted to support mandates.
- Clarifying leadership roles in areas where mandates overlap.

All these objectives are related and they can be met in many different ways. For example, an apex body (such as in Rwanda) could help in improving coordination among accountable bodies. Development of an overall tourism development strategy could also improve coordination. Adjusting the legal and regulatory framework would be critical to harmonizing mandates and clarifying leadership roles (about 44 Acts legislate on issues related to tourism).

For the wildlife tourism subsector, the objectives of policy and institutional reforms would be to engage local communities more in wildlife management and develop a comprehensive land use plan, particularly with a view to balance conservation and productive economic activities.

There is a need to give priority to improving public services that impact tourism directly. This would include rehabilitating key infrastructure that supports tourism and redoubling efforts to reduce crime in tourism hotspots such as Nairobi, Mombasa, Malindi, and roads to and from national parks.

The government will also need to assess the impact of tax policy on tourism activities. A value chain analysis of the tourism sector in Kenya reveals that about 45 to 55 percent of expenditure by tourists in the case of private conservancy is captured through various public sector charges (Table G-1). These charges appear high, particularly in view of the poor condition and low quality of public tourism infrastructure and public services. Policy options could explore giving
tax breaks to private operators based on proven investment in human and capital assets. The latter has been a very effective tool in countries like Costa Rica, Dominican Republic, and Malaysia.

Table G-1: Public Sector Share of Tourism Revenues from a Community-owned Wildlife Resource Conservancy in Partnership with a Private Tour Operator

<table>
<thead>
<tr>
<th>Public sector taxes, levies and fees</th>
<th>$US amount</th>
<th>Percent of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>VISA</td>
<td>50.00</td>
<td>3.9</td>
</tr>
<tr>
<td>Airport tax</td>
<td>20.00</td>
<td>1.6</td>
</tr>
<tr>
<td>Tax/surcharge (flight)</td>
<td>38.00</td>
<td>3.0</td>
</tr>
<tr>
<td>Airport charges (KAA)</td>
<td>-</td>
<td>0.0</td>
</tr>
<tr>
<td>Park fee (visitor)</td>
<td>101.31</td>
<td>8.0</td>
</tr>
<tr>
<td>Part fee (vehicles)</td>
<td>22.86</td>
<td>1.8</td>
</tr>
<tr>
<td><strong>Corporate income tax</strong></td>
<td>429.44</td>
<td>33.9</td>
</tr>
<tr>
<td><strong>VAT</strong></td>
<td>342.02</td>
<td>27.0</td>
</tr>
<tr>
<td><strong>Service tax</strong></td>
<td>203.00</td>
<td>16.0</td>
</tr>
<tr>
<td>Training Levy</td>
<td>40.60</td>
<td>3.2</td>
</tr>
<tr>
<td>Fuel levy</td>
<td>3.84</td>
<td>0.3</td>
</tr>
<tr>
<td>Speed governance</td>
<td>0.01</td>
<td>0.0</td>
</tr>
<tr>
<td>Driver/guide (PSV)</td>
<td>0.01</td>
<td>0.0</td>
</tr>
<tr>
<td>Guide license (Ministry of Tourism)</td>
<td>0.01</td>
<td>0.0</td>
</tr>
<tr>
<td>Pay as you go (Ministry of Finance)</td>
<td>2.97</td>
<td>0.2</td>
</tr>
<tr>
<td>NSSF/NHIF</td>
<td>0.65</td>
<td>0.1</td>
</tr>
<tr>
<td>Ministry of Tourism license</td>
<td>7.05</td>
<td>0.6</td>
</tr>
<tr>
<td>Local council license</td>
<td>2.11</td>
<td>0.2</td>
</tr>
<tr>
<td>Local council-environmental charges</td>
<td>2.97</td>
<td>0.2</td>
</tr>
<tr>
<td>Informal charges</td>
<td>0.20</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,267.05</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Total expenditure 51.2
Local expenditure 51.2

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