

An Employment- Targeted Economic Program for Kenya

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COUNTRY STUDY SUPPORTED BY THE INTERNATIONAL POVERTY CENTRE
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An Employment-Targeted Economic Program for Kenya: *Brief Highlights of Major Proposals*

The principal focus of our study is to develop effective policies for greatly expanding decent employment opportunities in Kenya. As we use the term, decent employment means a work situation that enables people to at least maintain him/herself and his/her family above a reasonable poverty line.

The government of Kenya has committed itself to generating 500,000 new jobs per year at least through 2007. We certainly embrace this goal. At the same time, there are wide disparities in the types of employment opportunities available in Kenya. A high proportion of people working full time at jobs are still unable to support themselves and their families above a poverty-line level. This is why it is crucial to not simply focus on employment alone, but the quality of employment.

EMPLOYMENT CONDITIONS AND LIVING STANDARDS

Labor force and unemployment. At the time of the most recent labor force survey in 2005-06, the total labor force—including all people employed and unemployed—totaled 13.5 million. Among the 18.8 million in their economically active years, this means a labor force participation rate of 72 percent. Of the 13.5 million participating in the labor force in some way, 12.1 million are counted as employed and 1.4 million are openly unemployed. Thus, the open unemployment rate is 10.5 percent.

Division of employment and incomes by sectors. We can divide the total number of jobs in the Kenyan economy into three broad categories—agricultural self-employment, the informal sector, and the formal sector. The breakdown of total employment by these three sectors is 50 percent in agricultural self-employment, 36 percent in the informal sector, and only 14 percent in the formal sector.

At the time of writing, the National Bureau of Statistics has not yet been able to release income data for those who are self-employed agricultural work-

ers. This means that we cannot report income data for fully half of all working people in Kenya. Nevertheless, we are able to report wage incomes for those working in the informal and formal sectors and net business earnings for self-employed workers in non-agricultural enterprises.

Incomes, on average, are much higher in the formal than informal sector. There are also significant income disparities between the categories of workers within each sector. Finally, there are also large disparities by region. Allowing for differences by employment categories, most private sector urban workers earn about twice as much as rural workers in the same job category. The urban/rural income disparities are small only between public sector employees.

Labor incomes and poverty. Of all Kenyans who are participating in the labor force but are unemployed, roughly 65 percent live in poverty, based only on earnings from employment. However, the proportion living in poverty are basically the same if a Kenyan is employed and working up to 39 hours per week. Specifically, for those working 1-27 hours per week, nearly 70 percent live in poverty. Among those working 28-39 hours per week, about 66 percent live in poverty.

Among the labor force participants working 40 hours or more per week, the percentage living in poverty does go down, to 46.1 percent. Still, this percentage remains very high. It means that, even among workers employed 40 hours or more per week, nearly 50 percent of them live in poverty.

The most serious problem facing Kenyans in the labor market today is not unemployment per se or even low hours per se. It is that, even among those Kenyans (outside the agricultural self-employed) who are working long hours—i.e. 40 hours or more—the chances are very high that one will be living in poverty.

PROFILE OF NON-AGRICULTURAL HOUSEHOLD ENTERPRISES

Based on the 2005-06 KIHBS, we find that there are a total of 2.1 million non-agricultural household enterprises in Kenya. Roughly 90 percent are informal enterprises and ten percent are formal. In terms of employment, about 5.2 million people are working in non-agricultural household enterprises, including contributing family workers.

Household Enterprises by Industrial Sectors. The overwhelming majority of non-agricultural household enterprises—82 percent of the total number of firms—are in the business of providing some sort of service. Of these service enterprises, 73.8 percent are informal and 8.2 percent are formal.

Employment in Household Enterprises. The largest category of employment in the household enterprise sector is unpaid family members, accounting by itself for 37 percent of all household enterprise employment. Own-account workers—people working alone for themselves—represent another 34 percent of all household enterprise employment. Thus, own-account workers and unpaid family members together account for more than 70 percent of all employment in household enterprises.

Costs of Operating Household Enterprises. The two largest categories of costs are the purchasing of goods that are resold—i.e. inventory purchases—and raw materials. In addition, there are large disparities between informal and formal enterprises in terms of the proportions they pay for licenses and taxes. Informal firms are paying an average of 3.8 percent of their total costs in licenses and taxes, while formal enterprises pay 8.5 percent. Thus, informal firms would have to increase their licenses and tax obligations quite significantly in order to operate as formal enterprises and receive the benefits from being a formal sector firm.

Sources of Start-Up Credit. The great majority of non-agricultural household enterprises rely on either their own savings or funds from family members to provide the initial financing for their businesses. SACCOs provide start-up funds to only 3.2 percent of household enterprises. The formal commercial banks appear to play almost no role whatsoever in helping household enterprises to begin operations.

Earnings from Household Enterprises. Most household enterprises in Kenya are informal and very small scale. The earnings that these firms receive, on average, are very low—not sufficient, on average, to maintain the people working in them above the official poverty line. If household enterprises are formal and relatively large in size, their earnings are dramatically higher.

Considerations for Policy. Three separate factors would seem crucial considerations for policy:

- raising productivity and expanding the domestic market in general, but also shaping policies so that household enterprises specifically will benefit from these overall economic gains;
- improving access to credit for household enterprises; and
- reducing the overall number of people relying on informal household enterprises, so as to reduce the excessive competition among them that keeps earnings at a poverty level. To do this will mean increasing opportunities for formal sector employment.

LABOR COSTS, LABOR MARKET INSTITUTIONS, AND EMPLOYMENT EXPANSION

It is frequently argued that a primary cause of insufficient employment opportunities is excessive labor costs that discourage businesses from hiring more workers. This perspective is prominent, for example, in the recent Concept Note written by the World Bank as a preliminary document to its ongoing *Jobs in Kenya* study (World Bank 2005a).

There are four possible ways in which the costs to businesses of hiring workers could fall: 1) workers receive lower overall compensation, including wages and benefits; 2) the industrial relations system and labor market regulations—including laws and regulations regarding workers' right to organize, conflict resolution, and hiring and firing—operates with more flexibility for business; 3) workers perform their workplace operations at a higher level of productivity; or 4) the government absorbs some portion of the costs of hiring workers.

In the World Bank's Concept Note, the focus appears to be on the first two ways to reduce business costs, i.e. to lower wages and benefits for workers and to increase the flexibility of the Kenyan formal labor market. We focus on these two considerations in this section of our study. We consider productivity and government employment subsidies later.

Wage Cutting

- We roughly estimate the amount of wage reductions needed to increase private formal sector employment by 25 percent, i.e. increasing employment in this sector by about 190,000 jobs, from 770,000 to 960,000. We find that average wages in the formal private sector would have to fall by approximately 42 percent.
- According to our calculations, cutting an average formal private sector worker's monthly wage by 42 percent would mean that the worker and his/her family income would fall to between 10 and 23 percent below their respective urban or regional poverty lines.
- About 400,000 Kenyans would experience a large increase in income. This would include both the 190,000 workers newly hired into formal sector jobs and the roughly 210,000 people who live off of the incomes of these workers. Despite these people enjoying rising incomes, they would, on average, also still be living between ten and 23 percent below their respective urban or regional poverty lines.

Beyond these immediate effects, the fact that 1.7 million people would experience a declining living standard would of course generate social unrest. This, in turn, would create an unstable atmosphere for private investors. The

decline in private investment would, in turn, lead to a contraction in job opportunities.

Industrial Relations and Labor Market Rigidities. To what extent has the expansion of decent employment opportunities in Kenya been hindered by the country's system of industrial relations, including regulations concerning hiring, hours, and firing; the extent and strength of union power in labor markets; and minimum wage standards? The World Bank's 2005 Concept Note suggests that these factors may be playing an important role in holding back employment growth in the private formal sector.

Yet the evidence is mixed at best, including data from the World Bank's own studies. It is reasonable to conclude from the most extensive World Bank study by Alby, Azam, and Rospabé (2005) that most business representatives in Kenya consider labor market regulations around hiring, firing, and hours to be relatively minor barriers to expansion, if they are barriers at all.

The Impact of Labor Unions. The World Bank's Concept Note suggests that labor unions may be operating as a significant source of labor market rigidities in Kenya. But the evidence suggests that this is unlikely to be a significant barrier to the expansion of decent employment. If for no other reason, this is because unions represent a small and diminishing portion of Kenya's labor force. Consistent with this, the Alby et al. study reports that in 2003, 93.6 percent of firms surveyed in Kenya reported losing zero work days due to strikes and labor unrest.

Minimum Wages. Kenya operates with a wide array of minimum wage orders that apply to different sectors, regions of the country, and job categories. However, in August 2007, the Ministry of Labor proposed abolishing all minimum wage standards.

- As of June 2006, the minimum wage laws are exerting little influence on actual wage-setting within the formal private sector. For example, between 43– 50 percent of formal private sector workers were earning wages below the lower-range average for the statutory minimum wage.
- Despite this lack of enforcement, the 2005 minimum wage laws have been serving a useful function in at least defining a decent standard that would enable working people and their families to live above the poverty line. Thus, to conclude that the minimum wage should be eliminated or significantly reduced from its current levels is to therefore also conclude that the Kenyan economy is unable to pay even those workers with jobs in the formal private sector a wage that will keep them and their families out of poverty.

- Labor market conditions in Kenya would probably benefit from a simplification of the elaborate system of minimum wage standards that are presently in place.

AGRICULTURAL SECTOR: INSTITUTIONAL REFORM FOR DEVELOPMENT

We consider specific conditions that prevail with Kenya's major crops, including tea and coffee, horticulture, maize and wheat, millet and sorghum, sugar cane and rice. We also discuss the livestock sector. These detailed discussions form the basis for our policy recommendations aimed at raising productivity and international competitiveness in the agricultural sector. The seven themes that we develop out of our discussions on the various agricultural sectors are these:

Learning from successes. Kenya has experienced successes in agriculture in a number of important areas. In terms of sectors, tea, horticulture and wheat stand out. We can extract valuable lessons from these successes. First, improvements have occurred when there is proper infrastructure and support for farmers or where farmers have sufficient capital to overcome structural impediments. Second, in some sectors it is possible for individual farmers or firms to exploit returns to scale to overcome impediments.

Adaptation rather than replication of past successes. Kenya's agricultural sector was broadly successful from independence until about 1980. But this doesn't mean that simply recreating the institutional environment or policies of the early independence years will be adequate for recreating a positive agricultural growth path. The aim of policy now should be to combine the management successes of the early independence years with a continued effort to promote the well-being of smallholders.

Understanding the resources and capabilities of smallholders. Most of Kenya's rural population has few assets in terms of resources or education. But the return to primary education for rural agricultural households is between eight and twelve percent per year. Assuring access to education for poor households would thus raise their agricultural productivity substantially.

Designing effective extension services for smallholders. A policy that aims to privatize extension is not likely to succeed with poor smallholders because they lack both the physical and human capital to make effective use of a private, demand-driven, extension service. Demand-driven extension works best for medium-

and large-scale farmers who have specific problems to be solved. Poor farmers tend to have a broader range of problems that need more than a single visit and require systematic training.

Returns to scale and agricultural cooperatives. Two crucial changes need to occur for cooperatives to play a successful role in agricultural development. The first is to create an effective regulatory body overseeing the operations of cooperatives and similar institutions. The second is increased public funding, probably through the Ministry of Cooperatives, to support the government's regulatory efforts, and to give positive guidance and support to these institutions.

Infrastructure improvements. We discuss elsewhere in the study proposals for improving Kenya's road and water infrastructure. Beyond these basic needs, there are also lessons to be learned from industries that have managed to absorb the increased costs imposed by poor infrastructure—particularly in terms of transportation and energy supplies—by taking advantage of returns to scale. This is particularly evident within the flower industry and KTDA.

Cost of capital and access to credit. The cost of and access to capital has long been a problem for smallholders. Apart from the high cost and difficulty of obtaining credit in the past, there has been a bias against smallholders in terms of the amount and the duration of loan. One approach to this situation is to dramatically increase the provision of affordable credit through rural-based SACCOs and other microfinance enterprises, through a program of credit subsidies, a topic that we consider at some length below.

INVESTING IN ROADS AND WATER INFRASTRUCTURE

Infrastructure investments are central to raising productivity and thereby people's incomes. Improving the country's infrastructure is equally important in terms of promoting trade competitiveness. Finally, increased public spending in these areas can serve as a major source of job growth within the country's formal economy, as has traditionally been the case in Kenya as well as many other countries.

- We argue for increased government spending on roads and water infrastructure at about Ksh 40 billion above present MTBSP commitments.
- This level of additional spending will bring major improvements in productivity. We also estimate that it will create roughly 350,000 new formal sector jobs.

MONETARY POLICY, INFLATION CONTROL, AND INTEREST RATES

The government's 2003 *Economic Recovery Strategy for Wealth and Employment Creation* states that its focus will be on four goals:

- contain inflation to below 5.0 percent;
- maintain a competitive exchange rate consistent with an export-driven economic recovery;
- maintain an interest rate structure that promotes financial savings and ensures efficient allocation of the same; and
- ensure adequate growth in credit to the private sector.

These are all important goals that are worthy in their own right. At the same time, in our view, this list of goals raises a set of serious concerns that require careful attention.

What is the Relationship between Inflation and Growth?

No professional consensus exists on the relationship between inflation and economic growth. At the same time, a few basic conclusions are evident:

- Virtually all research finds no clear negative relationship between growth and *single-digit* inflation specifically for the developing countries.
- This suggests that for Kenya, setting an inflation target below five percent is not likely to offer benefits in terms of the economy's growth performance.

Supply Shocks and Inflation Control

- Supply-side shocks have a major impact on inflationary dynamics in Kenya. As one important example, food price inflation, due to droughts or other breakdowns in the country's food production, raises the country's overall inflation rate and lowers living standards, particularly of poorer households. The same holds for oil price shocks.
- Tightening monetary policy in response to such events in order to maintain low inflation rates runs the risks of worsening the economic impact of these shocks. As such, it is important to try to observe how a shock to one component of the CPI affects other components. For example, how does a spike in food or energy prices affect other prices in the economy? Are these effects transitory or long-lived?

- We estimated a vector autoregression (VAR) model of the overall effects of supply-shock inflation. The findings from our VAR model suggest the following policy implications:
- *Food price shocks* do have a major direct impact on overall “headline” inflation in the short-run. And because food prices constitute over 50 percent of the overall CPI basket, these effects can impose serious hardships, especially for lower-income households. The most effective approach would be for the government to utilize its existing grain storage facilities throughout the country to provide an effective food buffer stock.
- *Energy price shocks* have a more sustained impact on inflation in Kenya. However, Kenya, acting alone, cannot do much to lessen the negative consequences of adverse movements in global oil prices, which feed into consumer energy prices. This is because Kenya imports all of its oil, and because building an oil buffer stock would likely be far more expensive than what could be developed for a food supply.
- *Transportation price shocks*, which partially reflect changes in fuel prices but also other components of transportation, such as bus and matatu fares, also appears to have a sustained impact on overall inflation in Kenya. In this case, the Kenyan government could take measures to lower transportation costs. One measure would be to improve the country’s transportation infrastructure. It is also important for the government to try to counteract short-term spikes in transportation prices.

We propose four basic changes in the conduct of monetary policy in Kenya.

1. *Use a core short-term real interest rate as an intermediate monetary target.* The Central Bank of Kenya should move away from targeting the growth rates of monetary aggregates. The Bank has little direct control over monetary aggregates and the links between monetary growth and macroeconomic performance, as defined by the quantity theory of money, are too weak to form the basis of a development-oriented monetary policy. Targeting real interest rates will have a more direct influence over interest rates and the exchange rate.
2. *Remove the anti-growth bias in monetary policy.* This involves a shift in the ways in which monetary policy is conducted. Specifically, monetary policy should be prepared to (1) provide economic stimulus during a contraction and (2) distinguish between demand-pull and cost-push inflation. The effectiveness of a counter-cyclical monetary policy will be enhanced if financial reforms insure that monetary policy has a direct impact on real economic performance.
3. *Diversify the toolkit for addressing inflation in Kenya.* Using monetary policy alone may be a costly way of reducing inflation in Kenya. This is particu-

larly likely to be true when inflation is the result of supply-side shocks. Multiple tools are needed to simultaneously control inflation and support a poverty-reducing development agenda.

4. *Institute reforms to the financial sector to channel credit to socially productive uses.* The Kenyan banking sector has substantial excess capacity that could be mobilized to facilitate the attainment of development objectives, such as employment creation, increasing productivity, enhancing investments, and supporting poverty reduction. However, at present, the financial structure does not channel credit to socially productive uses to a sufficient extent.

EXCHANGE RATE POLICY AND FOREIGN TRADE

The analysis in this section leads to the following policy conclusions:

- A targeted exchange rate policy is an important macroeconomic instrument for ensuring the competitiveness of Kenya's exports. It could also provide an appropriate economic environment for diversifying Kenya's export base.
- Kenya should focus on developing regional trade within the African continent. Kenya remains a net exporter to the continent and should remain competitive in this region as long as the appropriate policies are in place. Moreover, regional growth can have important positive feedback effects in the Kenyan economy.
- Targeted interventions aimed at promoting industrial expansion are needed to generate employment that reduces poverty in a way that is sustainable in the long run.

RESTRUCTURING THE FINANCIAL SYSTEM

The combination of a strong commercial banking sector and a widespread, vibrant but badly undercapitalized microfinance system suggests a clear policy approach: to bring into much closer alliance the formal commercial banking system and the microfinance institutions.

- We propose to create a pool of subsidized credit at a level equal to roughly 20 percent of the current level of private investment in Kenya. These funds would be made available to commercial banks, on condition that they in turn make loans to SACCOs and other MFIs. The MFIs would then be far more capable of making large amounts of loans to small businesses, informal enterprises, and agricultural small holders.

- We propose that guarantees be set at 75 percent of the loans that commercial banks make to MFIs. We demonstrate that, even assuming default rates on these guaranteed loans as high as 30 percent, the total accruals on these government contingent liabilities would amount to no more than Ksh nine billion, i.e., about five percent of the national budget.

FISCAL POLICY: HOW TO PAY FOR NEW PRO-EMPLOYMENT INITIATIVES

- We propose three major new areas of public expenditure beyond what has already been budgeted, in the areas of transport and water infrastructure; credit subsidies, especially for small businesses and rural smallholders; and improvements in marketing support, again, especially for small businesses and rural smallholders.
- According to our estimates, these three proposals should require expenditures of about Ksh 50 billion per year in 2005 prices, which is equal to about three percent of GDP.
- We propose these additional funds come primarily from two sources. The most important new source is tax revenues that should result from increased formalization of the economy. As a supplemental source of funds, the Treasury is well-situated to maintain its current level of borrowing from domestic sources, rather than following through on its current plan to significantly cut domestic borrowing. Other countries at similar levels of development carry more debt from domestic sources than the Kenyan Treasury; and many of these other countries have experienced successful growth trends in recent years, despite having higher domestic debt levels than Kenya.
- Possible external sources of increased government revenues include external borrowing, debt relief, and foreign aid. Each may be useful in generating small supplemental streams of revenue.

An Employment-Targeted Economic Program for Kenya: *Summary of Major Findings and Proposals*

The principal focus of our study is to develop effective policies for greatly expanding decent employment opportunities in Kenya. The term “decent work” has recently been embraced as an organizing principle by the International Labor Organization, and we believe the term has resonance for considering the situation in Kenya today. As we use the term in the Kenyan context, decent employment means a work situation that enables a worker to at least maintain him/herself and his/her family above a reasonable poverty line.

The government of Kenya has committed itself to generating 500,000 new jobs per year at least through 2007. We certainly embrace this goal. At the same time, there are wide disparities in the types of employment opportunities available in Kenya. A high proportion of people working full time at jobs are still unable to support themselves and their families above a poverty line level. This is why it is crucial to not simply focus on employment alone, but the quality of employment.

We are also not simply focused on improving employment opportunities for those near the poverty line. Among its sub-Saharan African neighbors, Kenya has a relatively highly educated population. There are also sectors of the Kenyan economy that are dynamic and generating healthy numbers of skilled, middle-class employment and business opportunities. Our proposals aim to expand opportunities for the poor and near poor in a manner that concurrently creates a wide range of employment and business opportunities. This includes all types of business owners—especially small and medium-sized enterprises, in the informal as well as formal sector, agricultural smallholders, as well as well-trained workers operating at high productivity levels.

Our program is in the spirit of the UN Millennium Development Goals, as they apply in Kenya. The MDGs are focused on raising standards of individual human welfare. The goals include the eradication of extreme poverty and hunger, universalizing primary education, equalizing opportunities for women, and improving a range of key health outcomes. Our own focus is less on these ends themselves than on the most effective means of accomplishing them.

Following an introductory Chapter 1, the main body of this work consists of nine chapters. The topics of these chapters are as follows: 2) employment conditions and living standards; 3) profile of non-agricultural household enterprises; 4) labor costs, labor market institutions and employment expansion; 5) the rural sector; 6) investing in roads and water infrastructure; 7) monetary policy, inflation control, and interest rates; 8) exchange rate policy and foreign trade; 9) restructuring Kenya's financial system; and 10) fiscal policy: how to pay for new pro-employment initiatives. We also present a brief concluding chapter that brings together our various proposals that are all aimed, in combination, toward promoting a large-scale expansion of decent employment in Kenya.

INTRODUCTION

Kenya's overall economic performance has been poor since the early 1980s, after having been generally positive in the first 15 years or so since the country became independent in 1964. We observe this shift in the country's economic trends through examining some basic evidence on GDP per capita, investment as a share of GDP, agricultural value added per worker, and the trade balance. Since 2004, there have been signs of improvement—including more rapid GDP growth per capita and higher rates of investment, and we consider this most recent evidence as well.

Why did the Kenyan economy descend into a long period of stagnation beginning in the early 1980s? Kenya's stagnation coincides closely with the 24-year presidential reign, between 1978 and 2002, of Daniel Arap Moi. As of this writing, President Mwai Kibaki has been in power for nearly five years. It is too early to render a judgment as to how successful the Kibaki administration has been in nurturing a more successful economic growth path. In any case, it is not our purpose to focus on the role of any single political figure or party in contributing to Kenya's economic decline.

Kenya's economic decline also correlates closely with the implementation of so-called "Structural Adjustment" policies under the auspices of the International Monetary Fund and the World Bank. These policies included: 1) fiscal policies targeted at keeping deficits low and reducing the overall level of spending; 2) monetary policy aimed at maintaining a low inflation environment as opposed to balancing the goals of inflation control and employment promotion; 3) liberalizing trade and capital flows; 4) privatization of publicly-owned enterprises; and 5) deregulation of the private business sector. This is not the place for a broad examination of the overall merits of this policy approach. However, we will consider how specific features of Kenya's structural adjustment program have affected the country's economic performance. We

will also propose changes in the country's policy approach based on the evidence we present.

Another factor that is widely seen as contributing to Kenya's economic stagnation is the high level of government corruption. Operating on a large scale, corruption can prevent vital policy initiatives from being carried out effectively. There is no doubt that for any positive policy initiatives to succeed, the level of corruption and mismanagement in Kenya's economy will have to be controlled more effectively. We offer suggestions, as appropriate in the context of our specific proposals, to consolidate advances already made toward controlling corruption.

Whatever factors have been responsible for Kenya's long economic stagnation, the severity of the country's economic problems were underscored during late 2005 and early 2006, when a severe drought in the northern part of the country drastically reduced food production and put 2-3 million people at risk of starvation. The drought and consequent humanitarian crisis was very much a regional phenomenon. Food supplies dropped to extremely low levels in the north, while agricultural production of such staple crops as maize was abundant in the west of Kenya. Kenya exported basic food crops to other African countries despite the acute food shortage in the arid and semi-arid regions in the north. The response of the Kenyan government and the international community was to increase emergency relief. However, a lack of food security and extreme volatility in agricultural production are perennial features of Kenya's agricultural sector that will not be addressed by a once-off disbursement of emergency aid. Kenya's food and water insecurity and the risk of famine are structural issues, rooted in a lack of transportation, communication, and water infrastructure.

Amid these serious economic difficulties, there are also many positive features of Kenya's economy today which need to be recognized. Indeed, one of our strategies in formulating new policy approaches has been to build from these many areas of achievement and future promise. These successful areas include:

- *Exports.* Kenya has continued to be among the world's leading exporters of tea. Moreover, the tea sector is characterized by a successful integration of smallholders along with large-scale farmers and processors. More recently, Kenya has also emerged as a leading horticultural exporter. We recognize that wages for workers in these sectors have not been consistently improving commensurate with the gains in export sales. This is clearly an important area for improvement.
- *Administration of infrastructure.* Though there is much evidence of governmental agencies failing to deliver on their procurement projects, the Kenya Roads Board has recently managed to successfully spend virtually their full road maintenance budget.

- *A vibrant financial system.* Kenya has a strong combination of institutions. At one level, sophisticated commercial banks operate along with emerging securities markets, with the country increasingly becoming a regional financial center. At another level, Kenya has the largest network of microfinance institutions in sub-Saharan Africa. The aim of policy should be to bring these two sets of institutions together.
- *Macroeconomic stability.* Kenya has never had a serious problem of inflation control. It has also succeeded in maintaining a fairly high level of tax revenue collections, which is all the more remarkable because most private economic activities are performed informally. Finally, Kenya has maintained a relatively low level of public debt. These are all positive achievements as far as they go. These should be seen as foundations on which to establish policies focused on promoting decent employment.

EMPLOYMENT CONDITIONS AND LIVING STANDARDS

In examining broad economic conditions and living standards, we have been fortunate to receive early access to the 2005–06 Kenya Integrated Household Budget Survey, produced by Kenya’s National Bureau of Statistics. We are grateful to our colleagues at the KNBS for this opportunity to utilize this invaluable resource.

Working with these 2005–06 KIHBS data, we observe these basic patterns. To begin with, total labor force participation—including all people employed and unemployed—is 13.5 million. Among the 18.8 million people in their economically active years, this means a labor force participation rate of 72 percent. Of the 13.5 million participating in the labor force in some way, 12.1 million are counted as employed and 1.4 million are openly unemployed. Thus, the open unemployment rate is 10.5 percent.

As is true in any economy, the figures on open unemployment provide a very limited picture of labor market conditions. This is because the open unemployment rate does not take into account underemployment, or more importantly, poverty-level employment—that is, people who are employed but are still bringing home low incomes. This could result from some combination of two factors: 1) receiving very low hourly income from employment; or 2) being employed involuntarily for a low number of hours. We therefore consider in this chapter evidence on poverty-level employment, along with data on open unemployment, sectoral employment, wages, and earnings.

Open Unemployment by Region, Gender and Age. There are large disparities in open unemployment by region, age, and educational levels, while differences by

gender are negligible. Thus, there is far more open unemployment in urban than rural regions—17.3 percent versus 8.5 percent. By age, the largest proportion of unemployed are those between 15 and 39 years old. In terms of educational attainment, the highest proportion of openly unemployed are those who have completed primary education, at 11.6 percent. It is notable that unemployment is not most severe among the least educated. Moreover, the percentage of openly unemployed among the most educated—i.e. those who have received higher education—is 8.5 percent, which is roughly on par with the 9.6 percent of those who have not completed primary education. In short, these figures show us that open unemployment is not a problem concentrated among the least advantaged groups in Kenyan society. It is rather a problem that is spread fairly evenly across different social groupings.

Division of Employment by Sectors. We can divide the total number of jobs in the Kenyan economy into three broad categories—agricultural self-employment, the informal sector, and the formal sector. The breakdown of total employment by these three sectors is 50 percent in agricultural self-employment, 36 percent in the informal sector, and only 14 percent in the formal sector.

Incomes from Employment. In considering these data, it is unfortunate that, at the time of writing, the KNBS has not yet been able to release income data for those who are self-employed agricultural workers. This means that we cannot report income data for fully half of all working people in Kenya. Nevertheless, we are able to report wage incomes for those working in the informal and formal sectors and business revenues for self-employed workers in non-agricultural enterprises.

We see from these data that, incomes, on average, are much higher in the formal than informal sector. There are also significant income disparities among the categories of workers within each sector. Finally, there are also large disparities by region. Allowing for differences by employment categories, most private sector urban workers earn about twice as much as rural workers in the same job category. The urban/rural income disparities are small only between public sector employees.

Labor Incomes and Poverty. The most recent poverty figures have been developed by the KNBS from the same 2005-06 Integrated Budget Household Survey, and are presented in their 2007 publication, *Basic Report on Poverty in Kenya*. Recognizing that the KNBS poverty thresholds are based on consumption rather than income levels, we proceed cautiously with these most recent poverty threshold figures to provide perspective on the median earnings figures for informal and formal sector workers in Kenya.

To begin with, the urban poverty line of Ksh 2,913 per month is about 25 percent below the Ksh 4,000 in median monthly earnings of both paid employ-

ees and self-employed own-account workers in the urban informal sector. Paid employees in the formal sector earn about three times the level of the Ksh 2,913 urban poverty line.

Now, of course, a high proportion of income earners have to support not only themselves with their earnings, but other family members as well. We assume for illustrative purposes that, for example, the average working person in Kenya supports one other person through his/her earnings, and we consider the implications of this in terms of poverty outcomes. First, for urban informal paid employees, dividing their Ksh 4,000 monthly earnings among two people means that each person lives on Ksh 2,000 per month. This is about one-third below the urban poverty line of Ksh 2,913. Even with urban formal paid employees, dividing Ksh 9,000 per month among two people means that both people are living on Ksh 4,500 per month. This amount is only slightly more than 50 percent above the urban poverty line. The story is similar in comparing the incomes of rural workers with the Ksh 1,562 rural poverty line.

Sources of Poverty-Level Employment: Low Hours and Low Earnings. We have found that, of all labor force participants for whom we have household income estimates, roughly 65 percent of the unemployed live in poverty, based on employment earnings alone. However, the proportions living in poverty are basically the same if a Kenyan is employed and working up to 39 hours per week. Specifically, for those working 1-27 hours per week, nearly 70 percent live in poverty. Among those working 28-39 hours per week, about 66 percent live in poverty.

Among those who report working 40 hours or more per week, the percentage living in poverty does go down to 46.1 percent. Still, this percentage remains very high. It means that, even among workers employed 40 hours or more per week, nearly 50 percent of them live in poverty. But it is also important here to recognize that a large majority of Kenyans do work 40 hours or more per week. This means, in turn, that even though the chances of living in poverty in Kenya do go down somewhat if one works 40 hours or more per week, it is still the case that the overwhelming proportion of labor force participants in Kenya who live in poverty are also working 40 hours or more per week.

Considering these data overall, a key message emerges, both for our study and for economic policy discussions in Kenya more generally. It is that the most serious problem facing Kenyans in the labor market today is not unemployment *per se* or even low hours *per se*. It is that, even among those Kenyans (outside the agricultural self-employed) who are working long hours—i.e. 40 hours or more—the chances are very high that one will be living in poverty.

PROFILE OF NON-AGRICULTURAL HOUSEHOLD ENTERPRISES

Non-agricultural household enterprises are a basic foundation of the Kenyan economy. Any strategy for expanding decent employment and reducing poverty in Kenya will have to focus on the non-agricultural household enterprise sector—to expand opportunities for people working in the sector, either by improving conditions within the sector itself or by creating more opportunities for decent employment outside this sector.

The 2005–06 KIHBS provides access to an unprecedented statistical portrait of this sector—its size, employment patterns, costs, sources of funds for financing expansion, and earnings. In this chapter, we present some of the most important statistical evidence that is now available.

There are a total of 2.1 million non-agricultural household enterprises in Kenya. Roughly 90 percent are informal enterprises and 10 percent are formal. In terms of employment, about 5.2 million people total are working in non-agricultural household enterprises, including contributing family workers. Of the 5.2 million employed in non-agricultural household enterprises, 4.1 million, or 79 percent are working in informal enterprises, and 1.1 million, or 21 percent, in formal enterprises.

Market for Household Enterprises. The domestic market within Kenya itself is by far the most important source of sales for Kenyan household enterprises, both the informal and formal firms. Almost no Kenyan household enterprise—less than one-tenth of one percent of the more than 2 million firms—sell a significant fraction of their goods and services on export markets. With respect to the domestic market itself, roughly 90 percent of non-agricultural household enterprises sell directly to consumers. Most of the remaining ten percent of these firms sell to private businesses within Kenya. Almost no household enterprises sell their products to the public sector.

Household Enterprises by Industrial Sectors. The overwhelming majority of non-agricultural household enterprises—82 percent of the total number of firms—are in the business of providing some sort of service. Of these service enterprises, 73.8 percent are informal and 8.2 percent are formal. Most of the remaining household enterprises are in manufacturing. Among the service-providing enterprises in this sector, the overwhelming majority are in retail trade. Retail trade itself accounts for a total of about 63 percent of all non-agricultural household enterprises.

Profile of Employment in Household Enterprises. The largest category of employment in the household enterprise sector is unpaid family members, accounting

by itself for 37 percent of all household enterprise employment. Own-account workers—people working alone for themselves—represent another 34 percent of all household enterprise employment. Thus, own-account workers and unpaid family members together account for more than 70 percent of all employment in household enterprises. The next largest category, 19.5 percent of all household enterprise workers, consists of employees working for someone else. Employers, those who are running household enterprises that include paid employees, represent only three percent of household enterprise employment.

Costs of Operating Household Enterprises. The two largest categories of costs are the purchasing of goods that are resold—i.e. inventory purchases—and raw materials. Across sectors, wages and salaries are not nearly as large a cost element as are inventories and raw materials, accounting, on average, for only 5.7 percent of total costs. There are large disparities in the relative size of the wage/salary bill when we move from considering informal to formal enterprises. With informal enterprises, wages and salaries account for only 4.8 percent of total costs, while, with formal household enterprises, wages and salaries rise to almost 14 percent of total costs.

One other important set of figures is the disparity between informal and formal enterprises in terms of the proportions they pay for licenses and taxes. Informal firms are paying an average of 3.8 percent of their total costs in licenses and taxes, while formal enterprises pay 8.5 percent. Thus, informal firms would have to increase their licenses and tax obligations quite significantly in order to operate as formal enterprises and receive the benefits from being a formal sector firm. Observing this large cost differential between informal and formal enterprises raises an obvious policy-related point: what are the benefits that would accrue to informal firms from joining the formal sector? Unless there are clear and significant benefits for firms in the formal sector, it will be to their obvious advantage to remain informal and face significantly lower costs in terms of licensing and taxes.

Sources of Start-Up Credit. The great majority of non-agricultural household enterprises rely on either their own savings or funds from family members to provide the initial financing for their businesses. Moreover, the differences between informal and formal enterprises are not large in this case. Overall, 52.3 percent of all household enterprises rely on their own savings, and another 21.8 percent rely on family gifts or loans. Savings and Credit Co-operatives provide start-up funds to only 3.2 percent of household enterprises. The formal commercial banks appear to play almost no role whatsoever in helping household enterprises to begin operations.

Earnings from Household Enterprises. In Chapter 2, we review earnings figures for individuals in the labor force. In this chapter, we consider earnings from the

perspective of the household enterprises as entities, as opposed to the people who are working in these enterprises, or other types of enterprises, in Kenya.

The median level of monthly earnings for all non-agricultural household enterprises is Ksh 2,370. This figure is 50 percent above the overall rural poverty line, and is 19 percent below the overall urban poverty line. What makes this low figure especially notable is that, as we saw, the largest single category of workers within household enterprises is “unpaid family members.” This means that, in a significant number of household enterprises, the overall earnings in the range of Ksh 2,400 per month is meant to supply a livelihood for more than one person working at the enterprise. Beyond these median earnings figures, there are also significant differences in earnings based on different factors. Earnings for informal sector firms are consistently lower than those for formal sector firms.

In general, we find that most household enterprises in Kenya are informal and very small scale. The earnings that these firms receive, on average, are very low—not sufficient, on average, to maintain the people working in them above the official poverty line. If household enterprises are formal and relatively large in size, their earnings are dramatically higher. However, it is obviously a great challenge for household enterprises to grow beyond operating as a small-scale firm since these firms have almost no access to credit. Moreover, the very large number of household enterprises in operations means that competition among them is necessarily strong.

Factors Influencing Household Enterprise Earnings. As part of our use of the 2005–06 KIBHS data set, we have conducted a formal statistical analysis of the factors that influence the levels of earnings for non-agricultural household enterprises. The key findings are as follows:

1. As noted at the outset of this chapter, household enterprises in Kenya sell almost exclusively within the domestic Kenyan market. But, within this framework, the enterprises that are able to sell to businesses within Kenya have higher earnings than the enterprises that are able to sell only to other households or to individuals on the streets. Therefore, forming linkages among household enterprises and other domestic businesses in Kenya should raise average earnings of household enterprises.
2. If an enterprise obtains start-up capital from a SACCO, this has a large and significant positive impact on earnings. This finding is especially important, given that, as we have observed above, less than four percent of household enterprises are currently receiving start-up credit from SACCOs.
3. If a household enterprise is involved in contingent or seasonal activities—that is, it operates for only a fraction of the year—this has a significant negative impact on the enterprise’s average monthly earnings.

4. The educational level attained by the manager/owner of a household enterprise will have a significant positive impact on earnings.
5. Women operating household enterprises on their own earn less than men in equivalent situations. This suggests that gender biases exist in the operations of household enterprises.

Considerations for Policy Proposals. Based on the findings we report in this chapter, three separate factors would seem crucial as considerations for policy:

1. Raising productivity and expanding the domestic market in general, but also shaping policies so that household enterprises specifically will benefit from these overall economic gains.
2. Improving access to credit for household enterprises. From the evidence we have presented, the level of involvement by the SACCOs, to say nothing of commercial banks, can be improved by a great amount.
3. Reducing the overall number of people relying on informal household enterprises, so as to reduce competition among them that keeps earnings below the poverty level. To do this will also mean increasing opportunities for formal sector employment.

LABOR COSTS, LABOR MARKET INSTITUTIONS, AND EMPLOYMENT EXPANSION

An explanation that economists frequently make as a cause of inadequate employment growth is that excessive labor costs are discouraging businesses from hiring more workers. This perspective is prominent, for example, in the 2005 Concept Note written by the World Bank as a preliminary document to its ongoing *Jobs in Kenya* study.

There are four possible ways in which the costs to businesses of hiring workers could fall: 1) workers receive lower overall compensation, including wages and benefits; 2) the industrial relations system and labor market regulations—including laws and regulations regarding workers' rights to organize, conflict resolution, and hiring and firing—operate with more flexibility for business; 3) workers perform their workplace operations at a higher level of productivity; or 4) the government absorbs some portion of the costs of hiring workers.

In the World Bank's preliminary Concept Note, the focus appears to be on the first two ways to reduce business costs, i.e. to lower wages and benefits for workers and to increase the flexibility of the Kenyan formal labor market. We focus on these two considerations in this section of our study. But we also provide some brief discussion in this section on raising productivity and government employment subsidies—i.e. using government subsidies as a way of reduc-

ing labor costs for business. We then also take up these latter two concerns in more depth later in the study.

Wage Cutting. To evaluate the net welfare effects of reducing wages in Kenya's formal economy, we need to begin by estimating how many new formal sector jobs are likely to be created through reducing wages. Once we have such an estimate, we can then assess the net benefits of such wage cuts. Let us assume for the purposes of this exercise that our aim is to increase private modern employment by 25 percent. From the 2005-06 KIHBS survey data, this would mean increasing employment in this sector by about 190,000 jobs, from 770,000 to 960,000 million jobs.

Economists estimate the relationship between relative changes in wage rates and employment levels through calculating a "wage elasticity of employment." Wage elasticities measure by how much we would expect employment to rise as a result of wage levels going down. We work with an elasticity of -0.6 for Kenya, which means that if wages were to fall by 10 percent, employment would rise by 6 percent. This means that to generate an additional 190,000 private sector formal economy jobs strictly through a strategy of wage-cutting, wages in the formal sector would have to fall by about 42 percent.

The median monthly wage level in the modern private sector as of 2005-06 was roughly Ksh 6,160. The breakdown between the urban and rural regions is an urban median wage of Ksh 9,000 per month, and a rural median wage of Ksh 4,800. This means that, for the urban formal sector, the median monthly wage would have to fall to Ksh 5,220. For the rural formal sector, the median monthly wage would have to fall to Ksh 2,784.

This means that, to generate an additional 25 percent increase in these jobs, the average monthly wage in the sector would have to fall to about Ksh 4,100. How significant would this wage cut be for workers and their families? According to our calculations, cutting an average worker's monthly wage to Ksh 4,100 would mean that the worker and his/her family income would fall to roughly 15 percent below the poverty line.

What would be the overall effects of this combination of wage cuts in the range of 40 percent for existing formal sector workers, with an expansion of about 190,000 jobs in the formal sector at the new, lower wage level? We calculate the net effect of the wage-cutting scenario—including all the workers receiving either wage cuts or wage increases and the additional people who live off of these workers' incomes—would be as follows:

1. Nearly 1.7 million Kenyans would see their living standard fall sharply. This would include both the 770,000 workers and the roughly 900,000 additional people who live off of the wages of these workers. These 1.7 million people would see their income levels fall, on average, to between

- 10 percent and 23 percent below their respective urban or rural poverty lines;
2. About 400,000 Kenyans would experience a large increase in income. As above, this would include both the 190,000 workers newly hired into higher-paying formal sector jobs and the roughly 210,000 people who live off of the income of these workers. Despite these people enjoying rising incomes, they would, on average, also still be living between 10 and 23 percent below their respective urban or rural poverty lines.

Beyond these immediate effects, the fact that 1.7 million people would experience a declining living standard will of course generate social unrest. This, in turn will create an unstable atmosphere for private investors. The decline in private investment will in turn lead to a contraction in job opportunities.

Industrial Relations and Labor Market Rigidities. To what extent has the expansion of decent employment opportunities in Kenya possibly been hindered by the country's system of industrial relations, including regulations concerning hiring, hours, and firing; the extent and strength of union power in labor markets; and minimum wage standards? The World Bank's 2005 *Concept Note* suggests that these factors may be playing an important role in holding back employment growth in the private formal sector. Yet the evidence informing these policy concerns is mixed, including data from the World Bank's own studies.

The most extensive set of evidence that relates to these issues comes from the World Bank's 2005 study, "Labor Institutions, Labor-Management Relations, and Social Dialogue in Africa," by Alby, Azam and Rospabé. This study presents results from surveys of businesses throughout Africa, and also offers comparative statistics from other regions of the world.

Alby et al. report findings on the views of business owners and managers on "difficulty of hiring," "rigidity of hours," and "difficulty of firing," as well as broader evidence on the costs of hiring and firing procedures. According to some of their findings, Kenya ranks very low in terms of the rigidity of employment conditions, at least as perceived by the country's business owners and managers. However, by other measures, Kenya ranks higher in terms of the costs associated with hiring and firing procedures. Overall then, the findings are mixed in terms of Kenya's rankings relative to other countries in the sample.

However, if we focus only on the results where Kenya comes out poorly in the rankings, the survey findings still do not support a conclusion that labor market rigidities in Kenya operate as significant barriers to employment expansion. Thus, even the figures where Kenya comes out least favorably—that is, in the findings on the number of firms citing layoffs and labor market regulations as significant obstacles—we still see only 21–22 percent of business owners cit-

ing this as a problem. This means that close to 80 percent of firm owners/managers do not see labor market regulations as a significant problem.

Thus, considering the overall weight of evidence presented by the Alby et al. study, and evaluating these findings in light of the propensity for some upward bias that is inherent in surveying business owners and managers on these questions, it is reasonable to conclude that most business representatives in Kenya consider labor market regulations around hiring, firing, and hours to be relatively minor barriers to expansion, if they are barriers at all.

The Impact of Labor Unions. The World Bank's Concept Note suggests that labor unions may be operating as a significant source of labor market rigidities in Kenya. But the evidence suggests that, as with the regulations on hiring, firing, and hours, this is unlikely to be a significant barrier to the expansion of decent employment. If for no other reason, this is because unions represent a small and diminishing portion of Kenya's labor force. The same 2005 World Bank study by Alby et al. reports that union membership in Kenya fell from 700,000 in 1985 to 436,036 in 2000, a decline of 38 percent.

The decline in union membership since the mid-1980s suggests that, to the extent that unions may have the capacity to operate as a rigidity in Kenya's formal labor market, the disruptive force of this rigidity should clearly have diminished sharply, not increased, since the mid-1980s. Consistent with this, the Alby et al. study reports that in 2003, 93.6 percent of firms surveyed in Kenya reported losing zero work days due to strikes and labor unrest.

The 2005-06 KIHBS provides some more recent figures on the extent of unionization in Kenya. We observe from this survey data that 1) membership in unions and welfare associations are concentrated in Kenya's formal public sector; 2) it is likely that about 70 percent of public sector employees are unionized, with the largest grouping being teachers and civil servants below the senior level; and 3) union membership in the private formal sector is probably around 20 percent of total employment in that sector.

A careful 2005 econometric study by Manda, Bigsten and Mwabu concludes that Kenyan unions do help formal sector workers obtain a wage premium in addition to getting protection from excessively long hours of work and from arbitrary job loss. At the same time, they find that elite-level workers in Kenya do not join unions, and thus, the gains generated by unions are received primarily by less-skilled production level workers.

As a general matter, relatively high rates of unionization do not necessarily serve as a barrier to expanding decent employment opportunities in Kenya or promoting the country's overall economic progress. Indeed, in 1995, the World Bank's own *World Development Report* noted that it is "possible to identify the conditions and policies under which free trade unions can advance rather than impede development." Following up on this, a more recent World Bank publi-

cation of 2003, *Unions and Collective Bargaining*, recognized that “high unionization rates lead to lower inequality of earnings and can improve economic performance in the form of lower unemployment and inflation, higher productivity and speedier adjustment to shocks.”

Minimum Wages. Kenya operates with a wide array of minimum wage orders that apply to different sectors, regions of the country, and job categories. In all, there are 45 separate minimum wage standards. However, in August 2007 the Minister of Labour, Dr. Newton Kulundu, announced that the government was planning to eliminate minimum wage standards.

What has been the impact of minimum wage standards on the actual wage levels paid in the formal private sector? We can obtain a sense of this by examining the data we report in Chapter 4 on actual wage levels as of 2005–06 relative to the statutory minimum wage standards. From these figures, we see that for workers paid hourly, about 73 percent are paid below the lowest average figure for the statutory minimum wage. Considering workers paid either on a daily or monthly basis—who constitute the overwhelming majority of paid employees—between 43 and 50 percent of private formal sector workers are earning wages below the lower-range average for the statutory minimum wage. These findings suggest that, as of 2005–06, the minimum wage laws are exerting little influence in actual wage-setting within the formal private sector.

Given their current ineffectiveness in setting actual wage floors, should the minimum wage laws be repealed, as is currently being proposed by the Labour Minister? In fact, the 2005 minimum wage laws have been serving a useful function in at least defining a decent standard that would enable working people and their families to live above the poverty line. Thus, to conclude that the minimum wage should be eliminated or significantly reduced from its current levels is to therefore also conclude that the Kenyan economy is unable to pay even those workers with jobs in the formal private sector a wage that will keep them and their families out of poverty. Rather than seek to eliminate or weaken a minimally decent wage standard in an effort to promote employment growth, it would seem preferable, at least as an initial endeavor, to pursue alternative policy approaches for expanding decent employment, including raising productivity, increasing access to credit, improving marketing capacity, and maintaining a more competitive exchange rate. At the same time, labor market conditions in Kenya would probably benefit from a simplification of the elaborate system of minimum wage standards that are presently in place.

THE RURAL SECTOR: INSTITUTIONAL REFORM FOR DEVELOPMENT

Any attempt at significantly improving employment opportunities and reducing poverty in Kenya cannot help but focus on the role of the rural population and the agricultural sector. Agriculture is of course a foundation of the Kenyan economy. Moreover, in the last two years, there seems to have been a clear upswing in agricultural production, accompanying the economy's general growth upswing. According to the government's *2006 Economic Survey*, the overall economy grew at 5.4 percent in 2005 while agriculture grew at 6.7 percent (Government of Kenya 2006c). This is in sharp contrast to the long-term stagnation and decline in agricultural productivity since the early 1980s. Will the agricultural sector be able to sustain its relatively positive growth of the past two years? In this chapter, we consider specific conditions that prevail with Kenya's major crops, including tea and coffee, horticulture, maize and wheat, millet and sorghum, sugarcane and rice. We also discuss the livestock sector. These detailed discussions form the basis for our policy recommendations aimed at raising productivity and international competitiveness in the agricultural sector. The seven themes that we develop out of our discussions on the various agricultural sectors are these:

Learning from Successes. Kenya has experienced successes in agriculture in a number of important areas. In terms of sectors, tea, horticulture and wheat stand out. The sugarcane producer Mumias is an important success story. From these successes we can extract a number of valuable lessons that may be useful in thinking about agricultural policy. First, improvements have occurred when there is proper infrastructure and support for farmers or where farmers have sufficient capital to overcome structural impediments. Second, in some sectors it is possible for individual farmers or firms to exploit returns to scale to overcome impediments. This has been true, for example, in the flower sector among farmers who are sufficiently capitalized. Among smallholders, for this to occur, either a collective farmer organization such as the Kenyan Tea Development Authority or a firm such as Mumias has to harness the returns to scale. But nurturing additional organizations of this type will require some form of government subsidy or participation.

Adaptation rather than Replication of Past Successes. Kenya's agricultural sector was broadly successful from independence until about 1980. But this doesn't mean that simply recreating the institutional environment or policies of the early independence years will be adequate for recreating a positive agricultural growth path. Many of the main supporting institutions, including the Kenya Meat Commission and the Kenya Cooperative Creameries, were formed in the colonial era and structured to support big farmers. These institutions did not change substantially after independence. And while it is true that many of the reforms that

were pursued in the 1980s and 1990s were poorly conceived, planned or implemented, or pushed by an overtly political objective, some of them were guided by a positive agenda of addressing the previous bias toward large-scale producers. The aim of policy now should be to combine the management successes of the early independence years with a continued effort to promote the well-being of smallholders.

Understanding Resources and Capabilities of Smallholders. Most of Kenya's rural population has little in terms of resources or education. These are the farmers who need to become small commercial producers in order for poverty to drop significantly in the short- to medium-term in the rural areas. In order to service these farmers better it is important for policymakers to recognize their capabilities and needs. The key point here is that most smallholders have had very limited formal schooling. The lack of formal education puts smallholders at a distinct disadvantage in comparison to other participants in agricultural markets. Husbands et al. (1996) estimated that returns to primary education for rural agricultural households were between 8 to 12 percent per year. Assuring access to education for poor households would thus raise their agricultural productivity tremendously.

Designing Effective Extension Services for Smallholders. The need for increased educational opportunities becomes clear in terms of improving the access to markets of smallholders. There is certainly a need for improvements in market access, as many observers in government and among donor agencies emphasize. At the same time, it is equally important to recognize that taking full advantage of the market opportunities that exist (for example, to export horticultural produce) requires a fair amount of human capital. In fact one of the reasons given for the failure of rural cooperatives is the low literacy of their members (Government of Kenya 2004). This point becomes relevant also in terms of designing improvements in extension services. For example, a policy that aims to privatize extension is not likely to succeed with poor smallholders because they lack both the physical and human capital to make effective use of a private, demand-driven, extension service. Demand-driven extension works best for medium scale and larger farmers who have specific problems to be solved (Schwartz 1994). Poor farmers tend to have larger problems that need more than a single visit and require systematic training.

Returns to Scale and Agricultural Cooperatives. The traditional collective organization for Kenyan farmers, both large and small, has been cooperatives. While the early cooperatives catered mainly to larger farmers in the 1950s and immediately after independence, the government encouraged smallholders to organize themselves into cooperatives for marketing and the purchase of inputs. By

2005 there were over 1.1 million members of 4,304 agricultural cooperatives. Cooperatives in Kenya have been closely associated with coffee farmers, with close to 50 percent of all members of an agricultural cooperative belonging to a coffee society. Both the early successes and more recent failures of the coffee cooperatives have been taken to be representative of the experiences with cooperatives and their prospects for the future. This is particularly true with respect to the failures of the coffee cooperatives.

Two crucial changes need to occur for cooperatives to play a successful role in agricultural development. The first is to create an effective regulatory body overseeing the operations of cooperatives and similar institutions. The second is increased public funding, probably through the Ministry of Cooperatives, to support the government's regulatory efforts, and to give positive guidance and support to these institutions. The 1997 Cooperative Act enabled farmers to obtain complete control over cooperatives, without any government regulatory oversight. It was the subsequent absence of any effective regulatory structure that encouraged mismanagement of the cooperatives, and the collapse of the coffee cooperatives.

Infrastructure Improvements. We discuss elsewhere in the study some proposals for improving Kenya's road and water infrastructure. Beyond these basic needs, there are also lessons to be learned from industries that have managed to absorb the increased costs imposed by poor infrastructure—particularly in terms of transportation and energy supplies—by taking advantage of returns to scale. This is particularly evident within the flower industry and KTDA. KTDA maintains a fleet of trucks that guarantees access to markets for its members, accepting that the costs of this measure are high. In the short term, one approach to dealing with the transportation problem and increasing market access for small farmers could be the organization of transport collectives. These cooperatives could be responsible for transporting smallholder crops to major urban areas and to bring back to the farmers the major inputs—seed, fertilizer, pesticides—which are generally more available and cheaper in the major urban areas.

Cost of Capital and Access to Credit. The cost and access to capital has long been a problem for smallholders. Apart from the high cost and difficulty of obtaining credit in the past there has been a bias against smallholders in terms of the amount and the duration of loan. For example, between 1980 and 1986, the most recent period for which data are available, large farmers received most of their loans with relatively long-term maturities of over seven years as long-term loans. By contrast, smallholders virtually never received long-term loans. One approach out of this situation is to dramatically increase the provision of affordable credit through rural-based SACCOs and other microfinance enterprises, a topic that we consider at some length below.

INVESTING IN ROADS AND WATER INFRASTRUCTURE

Infrastructure investments are central for raising productivity and thereby people's incomes. Improving the country's infrastructure is equally important in terms of promoting trade competitiveness. Finally, increased public spending in these areas can serve as a major source of job growth within the country's formal economy, as has traditionally been the case in Kenya as well as many other countries.

Recognizing the centrality of investing in the country's infrastructure, the 2006 MTBSP commits to increasing the share of government resources going to physical expenditures from 19.2 percent in 2005-06 to 21.6 percent in 2008-09. The MTBSP states its priority areas as being the expansion and improved maintenance of road networks and other public works. It has also prioritized increasing access to water resources, along with the provision of affordable energy. This increased level of spending for the country's infrastructure is certainly needed. However, we believe that these expenditure commitments need to increase significantly beyond even these enhanced projected levels. To illustrate this point, we focus on the areas of transport and water infrastructure because these are the two most urgent areas of need.

Roads. Road transportation accounts for roughly 80 percent of all transport in Kenya. It is also the form of transportation with the most straightforward fiscal implications. The impact of improvements in the rural road infrastructure is potentially large.

Kenya currently has 28,500 km of national and urban roads and an additional 150,000 of rural (mostly dirt or gravel) roads. According to the KRB, a 2002 survey found that approximately one-third of Kenya's national and urban roads are in poor repair. The estimated cost of rehabilitating all these poor roads is Ksh 228 billion. Suppose that we set a goal of rehabilitating all of these poor quality roads within 12 years. The real annual cost (not factoring in inflation or the cost of other repair activities) would be roughly Ksh 19 billion per year—i.e. approximately twice the current budget of the KRB. This suggests that, despite the significant budget reprioritization to support road infrastructure, Kenya's roads will remain substandard in the foreseeable future unless additional resources are made available.

Lack of financial resources is only one of two basic problems that Kenya must overcome if it is going to significantly improve its transportation infrastructure. The other, equally serious concern, is the government's capacity to complete projects that already have received adequate funding allocations, with the funds at the Treasury, waiting to be spent. The single largest budgetary item here is for road maintenance. For 2004-05, Ksh 8.6 billion was allocated for

maintenance, and virtually all of these funds were spent. The country's road maintenance program is evidently operating at a high level of efficiency. However, road construction programs, as well as the smaller planning and design programs, were unable to spend a high proportion of their allocations.

A few important points emerge from these figures. The first is that, because the maintenance program is operating so much more effectively than the other programs, it should therefore continue to receive the largest share of budgetary allocations. Second, in order to improve efficiency in the road building areas, the successes in the road maintenance program should be examined carefully for lessons that may be applicable to the construction projects. Finally, and related, the government needs to initiate measures to raise productivity linked to the completion of new road projects. Such measures could be regarded as one significant component of an overall program to "mainstream productivity" in all areas of the country's economic management.

Water. Kenya is a water-scarce country. Renewable freshwater endowments currently stand at 600–700 m³ per person per year. A country is categorized as "water scarce" if it has less than 1,000 m³ per capita in renewable freshwater resources. In addition, water resources are unequally distributed across geographical regions in Kenya. The arid and semi-arid lands, which cover a large part of the land surface in northern Kenya, are particularly vulnerable due to a lack of water security. Water insecurity was the single greatest problem associated with the recent famine in 2005–06.

Currently, Kenya has irrigation infrastructure in place to service about 105,000 hectares of agricultural land. This is less than one fifth of the estimated full irrigation potential of the country – about 540,000 hectares. The cost of expanding irrigation infrastructure to meet the country's full potential is high – involving physical infrastructure, compensation for the employees working on these projects, and purchase of land for the construction of irrigation facilities.

In addition to the deficiencies in the irrigation system, water storage facilities are also in poor condition in Kenya. Excluding hydroelectric facilities, the per capita water storage capacity in Kenya stood at just 4.3 m³ per person in 1999. In 1969, three decades earlier, the estimated water storage capacity was three times higher, at 11.4 m³. This 1969 level of storage capacity was itself low. But the fact that capacity has diminished in absolute terms since 1969 is a major matter of concern.

To raise the country above the threshold for water security, another 350 m³ in water storage capacity would be needed. Financing an increase in water storage at this level would cost an additional Ksh 37.5 billion per year for 30 years, equal to about 2.5 percent of GDP. We conduct a costing exercise in which we allow for a budget at roughly this level, which would mean increasing the al-

ready planned budget by about Ksh 20 billion per year. Of course, the issue of whether the funds will be utilized efficiently cannot be assumed away. As with the road construction projects, the successful completion of projects that have already received their funding allocation may be at least as much, if not more, of a problem than receiving the budgetary allocation itself. Actual spending falls short of budgeted spending in a number of areas. However, the efficiency of delivery varies from one category of water infrastructure to the next. For example, planned and actual expenditures are reasonably well matched for the construction and rehabilitation of dams, pans, and dykes and flood control projects.

Employment Effects of Expanding Roads and Water Infrastructure Spending. We conduct an exercise in which we assume that all the road and water projects operate at a budgetary allocation as we have described in the foregoing discussions—i.e. at a funding level of roughly Ksh 40 billion greater than the current allocation levels projected through 2008-09 in the MTBSP. What would be the impact of this increased level of spending in terms of employment within the country? According to our estimate, this amount of increased spending will directly produce 333,000 jobs, assuming that workers on these projects receive an average wage rate of Ksh 5,000 per month. In addition, we roughly estimate that another 20,000 jobs in wage employment will be indirectly generated through multiplier effects—i.e. the increase in employment that comes from the 333,000 newly employed workers spending their wage income in Kenya's economy.

MONETARY POLICY, INFLATION CONTROL AND INTEREST RATES

The government's 2003 *Economic Recovery Strategy for Wealth and Employment Creation* states that its focus will be on four goals:

- Contain inflation to below 5.0 percent;
- Maintain a competitive exchange rate consistent with an export-driven economic recovery;
- Maintain an interest rate structure that promotes financial savings and ensures efficient allocation of the same; and
- Ensure adequate growth in credit to the private sector.

These are all important goals that are worthy in their own right. At the same time, in our view, this list of goals raises a set of serious concerns that require careful attention. Our concerns are as follows:

1. Containing inflation below 5.0 percent could operate as a significant obstacle to promoting economic growth, employment expansion, and poverty reduction.
2. Maintaining a competitive exchange rate and promoting export growth is highly desirable. However, the economy of Kenya at present is heavily dependent on imports in the areas of energy products, chemicals, equipment, and machinery. Thus, the goal of promoting exports must be advanced within the framework of also reducing import-dependency in these areas.
3. Promoting an efficient allocation of financial savings and ensuring an adequate growth in credit to the private sector are crucial to the country's growth prospects. But it is not likely that monetary policy by itself can reconcile these two goals, especially in the context of also attempting to maintain inflation below 5.0 percent. Other policy interventions will be needed to encourage an efficient allocation of credit to the private sector.

We address each of these issues in this and the following chapters. In this chapter, we focus on inflation control and the operating procedures for monetary policy. In the next two chapters we consider the exchange rate and trade, and in Chapter 9, we propose ways to restructure the financial system to promote growth and employment expansion.

Inflation and Economic Growth. We first review some relevant literature on the relationship between inflation and growth. We then consider the evidence in Kenya that relates the effects of supply shocks—in particular large spikes in the prices of energy, food and transportation—on overall inflation in the country. We finally discuss alternatives to tight monetary policy as an approach to inflation control.

What is the relationship between inflation and growth? Answers to this question vary widely in the professional literature. Some of the most influential recent studies were those produced by the late Michael Bruno, who had been Chief Economist at the World Bank at the time he conducted his studies.

Considering the findings from all the studies reviewed in this chapter, it is clear that no consensus exists on the relationship between inflation and economic growth. At the same time, a few basic conclusions from these various studies that are relevant for the Kenyan case do seem warranted. One major conclusion is that regardless as to whether researchers observe a negative growth/inflation relationship emerging in the low or high double-digit range for developing countries, only one study found a clear negative relationship between growth and *single-digit* inflation specifically for the developing countries. This suggests that for Kenya, setting an inflation target below 5.0 percent is not likely to offer benefits in terms of the economy's growth performance. If Kenya chooses to follow the low-end finding within the professional literature on the inflation/growth trade-off, that would still suggest an inflation target in the range of 8-9 percent.

Supply Shocks and Kenyan Inflation Control. Supply-side shocks have a major impact on inflationary dynamics in Kenya. As one important example, food price inflation, due to droughts or other breakdowns in the country's food production, raises the country's overall inflation rate and lowers living standards, particularly of poorer households. Rapid increases in global oil prices have similar effects on the Kenyan economy. Tightening monetary policy in response to such events in order to maintain low inflation rates runs the risks of worsening the economic impact of these shocks. As such, it is important to try to observe how a shock to one component of the Consumer Price Index affects other components. For example, how does a spike in food or energy prices affect other prices in the economy? Are these effects transitory or long-lived?

To investigate these questions, we estimated a vector autoregression (VAR) model that includes the 10 components of the Kenyan CPI as variables. Overall, the findings from our VAR model suggest the following policy implications:

1. Food price shocks do have a major direct impact on overall "headline" inflation in the short-run. And because food prices constitute over 50 percent of the overall CPI basket, these effects can impose serious hardships, especially for lower-income households. At the same time, these effects are transitory. The most effective approach would be for the government to utilize its existing grain storage facilities throughout the country to provide an effective buffer stock of food that is readily accessible.
2. Transportation and communication price shocks—which, according to the Kenyan CPI, includes petrol, diesel, car service, insurance, tax fares, matatu fares, postage, and phone calls—have systemic effects on other prices in the Kenyan economy, even though they constitute only 5.7 percent of the overall CPI. These prices are, of course, heavily affected by global oil prices. The most direct channel is through the petrol and diesel price components. But car service, taxi fares, bus fares, and matatu fares will also be affected by an oil shock. In the short term, the most effective means of counteracting the effect of global oil price shocks would be for the government to quickly increase its subsidy for public transportation, including bus and matatu fares. Over the longer term, investments in the country's transportation infrastructure, especially its roads system, will lower the overall share of transportation costs in the CPI, and thereby mitigate the effects on the overall CPI of a short-term oil price shock.
3. Energy price shocks—including here, electricity, water, paraffin, cooking gas, and charcoal prices—also have a sustained, systemic impact on inflation in Kenya. As with the transportation and communications component of the CPI, the only way that the government can counteract the effects of

a global oil price spike would be to subsidize the prices of these components of the CPI in the short-run. This would short-circuit the long-lasting effects of these price increases on the overall CPI.

Additional Inflation Control Tools. The weight of the professional literature suggests that, as Kenya continues to advance an aggressive program of employment expansion, it should not weaken the program as long as inflation remains moderate. But what happens if inflation accumulates momentum, such that a rise to a ten percent inflation rate leads to still greater inflationary pressures? Should Kenya then revert to stringent growth in the money supply as a means of raising interest rates? In fact, other policy tools are available for their use, through which Kenya could contain inflation within a moderate range, without having to rely on high interest rates as its primary control mechanism.

One tool would be to pursue so-called “incomes policies.” Incomes policies have been developed in various specific ways, but the basic idea is straightforward: that wage and price increases are negotiated on an economy-wide basis between labor and business in the formal economy. The most basic critique of incomes policies is that, in order for the approach to have any chance of success, it is necessary that a country operate with a high level of organization among workers, and that there be some reasonable degree of common ground between workers and business. Otherwise, there will be no realistic prospect for economy-wide bargaining to yield results that will be honored widely. In the case of Kenya, the establishment of the Productivity Centre offers a real possibility that incomes policies could be broadly agreed upon as a tool for dampening inflationary pressures before they reach dangerous levels.

Conduct of Monetary Policy. We focus here on three concerns: 1) the specific procedures and policy tools being used in Kenya; 2) how some of these procedures may contribute to worsening cyclical fluctuations rather than dampening them; and 3) how the focus on controlling inflation may contribute to excessively high interest rates. Based on our discussions of these points, we then propose five basic changes in the conduct of monetary policy in Kenya. These are:

1. *Use a core short-term real interest rate as an intermediate monetary target.* The Central Bank of Kenya should move away from targeting the growth rates of monetary aggregates. The Bank has little direct control over monetary aggregates and the links between monetary growth and macroeconomic performance are too weak to form the basis of a development-oriented monetary policy. Targeting real interest rates will have a more direct influence over critically important macroeconomic prices.

2. *Remove the anti-growth bias in monetary policy.* This involves a shift in the ways in which monetary policy is conducted. Specifically, monetary policy should be prepared to (1) provide economic stimulus during a contraction and (2) distinguish between demand-pull and cost-push inflation. The effectiveness of a counter-cyclical monetary policy will be enhanced if financial reforms insure that monetary policy has a direct impact on real economic performance.
3. *Diversify the toolkit for addressing inflation in Kenya.* Using monetary policy alone may be a costly way of reducing inflation in Kenya. This is particularly likely to be true when inflation is the result of supply-side shocks. Multiple tools are needed to simultaneously control inflation and support a poverty-reducing development agenda. Monetary policy should not be expected to operate effectively on its own.
4. *Institute reforms to the financial sector to channel credit to socially productive uses.* The Kenyan banking sector has substantial excess capacity that could be mobilized to facilitate the attainment of development objectives, such as employment creation, increasing productivity enhancing investments, and supporting poverty reduction. However, at present, the financial structure fails to channel sufficient credit to socially productive uses.

EXCHANGE RATE POLICY AND FOREIGN TRADE

Over the past several decades, Kenya has moved towards increasingly market-determined trade and exchange rate regimes. The import-substitution strategy of the 1960s and 1970s, with its protectionist measures to encourage domestic production, has been gradually replaced by a stronger export orientation, with reductions in tariffs and quantitative restrictions. At the same time, Kenya's fixed exchange rate regime was replaced by a crawling peg which, in turn, was eventually replaced by a floating regime. Despite an expansion of trade in the early 1990s, these reforms have not been successful in addressing Kenya's structural problems, including sustained trade and current account deficits. In addition, Kenya's productive structure has remained relatively unchanged throughout this period, apart from a few significant developments, including the growth of horticultural exports and the expansion of trade among other African countries. Moreover, trade liberalization appears to have had a net negative impact on employment opportunities, with important implications for poverty reduction.

With regard to exchange rate policies, the evidence suggests that, after the shift to a market-determined rate, the shilling has recently become overvalued. This runs contrary to the predictions of the proponents of non-intervention in the foreign exchange market. Although overvaluation may make imported in-

puts cheaper and could reduce inflation, it has had an adverse effect on exports. While the precise degree of overvaluation is difficult to assess, the analysis presented here suggests that impact of overvaluation has not yet been severe. However, the degree of overvaluation may be stronger with respect to Kenya's major trading partners in Africa. This could be a barrier preventing Kenya from capturing the benefits of greater regional trade integration.

There are reasons to think that overvaluation may be a bigger concern in the future. Inflows of capital and remittances into Kenya appear to have increased recently, including inflows of so-called "hot money." In addition, the world boom in commodity prices may produce so-called "Dutch disease" effects, in which the shilling becomes increasingly overvalued with negative consequences for the domestic economy. The data presented here suggests that the shilling was relatively more competitive when Kenya was targeting its real exchange rate using a managed regime, such as a crawling peg.

Analysis of the determinants of export performance and import penetration indicate that exports tend to respond more strongly to changes in prices as opposed to changes in incomes within the economies of Kenya's main trading partners. The reverse holds true for imports. Kenya's imports rise and fall sharply along with increases and declines in Kenya's own national income. However, price increases in imported products such as oil does little to reduce the demand for oil imports. Therefore, managing the real exchange rate through active policy interventions may be important for promoting new and more diverse types of exports. However, exchange rates appear to have less of an impact on imports. This raises the question of how Kenya's excessive dependence on imported inputs and capital goods could be reduced. Targeted policies such as the credit allocation schemes discussed above that actively underwrite the country's industrial expansion could be instrumental in addressing these structural problems.

Three broad directions for policy emerge from the analysis presented here:

1. A targeted exchange rate policy is an important macroeconomic instrument for ensuring the competitiveness of Kenya's exports. It could also provide an appropriate economic environment for diversifying Kenya's export base.
2. Kenya should focus on developing regional trade within the African continent. Kenya remains a net exporter to the continent and should remain competitive in this region as long as the appropriate policies are in place. Moreover, regional growth can have important positive feedback effects in the Kenyan economy.
3. Targeted interventions aimed at promoting industrial expansion is needed in order to generate employment that reduces poverty in a way that is sustainable in the long-run.

RESTRUCTURING THE FINANCIAL SYSTEM

As noted above, Kenya's financial system already has some important positive features. These include:

1. Kenya's commercial banking system is generally well-developed, and by some standard performance measures, is more focused on lending to the private sector than is the case in other sub-Saharan African countries.
2. Kenya is developing as a regional financial center, with emerging securities markets.
3. Kenya has a widespread system of microfinance institutions (MFIs) already in place and operating. SACCOs are the most important of these institutions. But there are others, both formal and informal, client- and member-based. These include the Kenya Rural Enterprise Program bank (formal, client-based) and ROSCAs (Rotating Savings and Credit Associations, which are informal, member-based).

Despite these positive features, the contributions of the financial system to promoting economic growth, employment expansion and poverty reduction are inadequate. In our view, the main reasons for this inadequate performance are as follows:

1. Interest rate levels are high in *nominal* terms—that is, before making any adjustments for inflation. Rates aren't necessarily high in *real* terms—i.e. after subtracting the inflation rate from the nominal interest rate. But knowing whether *real* interest rates are high or low depends on movements in the rate of inflation. This creates considerable uncertainty in the financial system.
2. More significant than problems with interest rate levels are the spreads between deposit and lending rates, which are extremely wide. Again, depending on how one calculates a real interest rate, most deposit rates are actually negative. There is therefore no incentive to save in formal financial markets. These wide interest rate spreads indicate lack of competition in the commercial banking system.
3. The commercial banking system lends more than one-third of its deposit base to the government. This of course reduces the availability of funds for businesses, especially SMEs and small farmers.
4. More generally, the farming, SME and informal sectors are starved for credit. This is due to the fact that a) commercial banks do not generally lend to these sectors; and b) the SACCOs and other MFIs do not have sufficient resources to provide large-scale funds. Moreover, the largest share of the lending done by the MFIs is for personal household purposes or family emergencies.

Given this combination of positive and negative features of the Kenyan financial system, the solution to the problem, at a fundamental level, seems straightforward: to somehow bring into much closer alliance the formal commercial banking system and the MFIs. In fact, proposals along these lines have been suggested by, among others, the World Bank in a 1994 study on Kenya specifically, and the International Monetary Fund in a more general 2005 study on sub-Saharan African finance. This idea has also been raised in some previous research papers by Kenyan scholars (e.g. Atieno 2001). What remains is to flesh out a large-scale program that could be realistically implemented on a short-term basis, but that is also capable of enabling a longer-term transformation of the Kenyan financial system.

The proposal that we present here will create a pool of subsidized credit at a level equal to roughly 20 percent of the current level of private investment in Kenya. These funds would be made available to commercial banks, on condition that they in turn make loans to SACCOs and other MFIs. The MFIs would then be far more capable of making large amounts of loans to small businesses, informal enterprises, and agricultural smallholders. We propose that guarantees be set at 75 percent of the loans that commercial banks make to MFIs. We demonstrate that, even assuming default rates on these guaranteed loans as high as 30 percent, the total accruals on these government contingent liabilities would amount to no more than Ksh 9 billion, i.e., about 5 percent of the fiscal budget.

We also briefly discuss other complementary initiatives in this chapter. These include: reviving cooperative-type institutions to build collateral for SMEs and smallholders; revitalizing the public investment banks, such as the Industrial and Commercial Development Corporation and the Agricultural Development Bank, perhaps as private/public partnerships; utilizing the Postbank as a lender to SMEs, an idea that has already passed the Parliament; and indexing loans so as to shift, at least in part, inflation risk from lenders to borrowers.

FISCAL POLICY: HOW TO PAY FOR NEW PRO-EMPLOYMENT INITIATIVES

As we have seen, we are proposing three major new areas of public expenditure beyond what has already been budgeted—for road and water infrastructure; credit subsidies, especially for small businesses in the formal and informal sectors, and smallholders; and for marketing, cooperatives, extension services, and grain storage. According to our estimates, these three proposals should require expenditures of about Ksh 52 billion per year in 2005 prices, which is equal to about 3 percent of GDP.

For the fiscal year 2007–08, the Treasury has estimated total expenditures at 25.5 percent of GDP and revenues of 20.9 percent of GDP. This implies a deficit of 4.6 percent of GDP, with the projection that this deficit will fall to 4.2 percent of GDP in 2008–09.

How would we propose to finance these existing expenditures? We need to consider this question in the context of two other important considerations: 1) the Treasury is committed to reducing its level of outstanding debt, which now stands at 41.4 percent of GDP, of which 18.2 percent is domestic debt while 23.1 percent is external debt; and 2) the current budget projections assume donor support, in the form of grants and loans, amounting to about 4.3 percent of GDP as of 2007–08 and 2008–09. It is probably not prudent to assume that this figure could or should rise much higher.

Given these considerations, the question that arises is how the Treasury would finance the additional spending programs we are proposing. There are five ways in which additional public revenues could be made available to finance the policies that we are suggesting. They are:

1. increased collection of taxes from domestic sources;
2. increased domestic borrowing;
3. increased external borrowing;
4. debt relief or complete forgiveness by foreign creditors; and
5. overseas development assistance providing direct budget support.

In our view, the two most viable sources for generating increased tax revenues in both the short- and longer-term are the two domestic sources, i.e. higher domestic tax revenues and maintaining, rather than cutting, existing levels of domestic borrowing. For various reasons that we discuss briefly at the end of this chapter, the three external sources are all less promising. Still, they each may be useful in generating small supplemental streams of increased government revenue.

The largest potential for increasing tax revenues will be through increased formalization of the economy. The programs we are proposing—in the areas of credit subsidies, export promotion, and infrastructure investments—all aim to increase the share of the formal sector of Kenya's economy. Moreover, over a relatively short time period, the expansion of the formal sector would need to be only modest to fully cover the costs of the programs we have proposed. We show that a relative shift of Kenya's economy in favor of the formal sector from 15 to 20 percent of total employment would itself more than pay for the increased expenditures we are proposing.

Maintaining the government's current level of domestic borrowing would be a viable supplemental measure to finance the additional expenditure. The impact of this increase in government borrowing on the government's long-

term fiscal program would be modest. Thus, the Treasury has projected that domestic debt will fall from 18.6 to 16.5 percent of GDP between 2006-07 and 2008-09. The measures we are proposing would entail that domestic debt would remain basically at its current level relative to GDP rather than to fall. Over 1997-2004, the government's average level of domestic debt was 21.8 percent of GDP. This is a relatively modest figure, seen in comparison with a sample of other countries. Our sample includes Swaziland, Rwanda, Burundi, Sierra Leone, Cameroon and Mauritius from sub-Saharan Africa; and, additionally, Honduras, Costa Rica, Malaysia, India and Sri Lanka. Of course, many of this latter group of countries have experienced successful growth trends in recent years, despite many having higher domestic debt levels than Kenya.