An Assessment of the Investment Climate in Kenya

Giuseppe Iarossi
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Giuseppe Iarossi

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Abbreviations

AIDS acquired immune deficiency syndrome
COMESA Common Market for Eastern and Southern Africa
COMTRADE Common Format for Transient Data Exchange
DFID UK Department for International Development
EPZ export processing zone
FSD Financial Sector Deepening
FY fiscal year
GDP gross domestic product
GoK government of Kenya
HCDA Horticultural Corps Development Authority
HIV human immunodeficiency virus
ICA Investment Climate Assessment
IFC International Finance Corporation
ISO International Organization for Standardization
IT information technology
KIPPRA Kenya Institute for Public Policy Research and Analysis
KPLC Kenya Power and Lighting Co. Ltd.
K Sh Kenya shilling
kWh kilowatt hour
LCSPS Latin America and Caribbean Public Sector Group
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<tr>
<td>LEGJR</td>
<td>Legal and Judicial Reform Practice Group</td>
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<tr>
<td>MSME</td>
<td>Micro, Small, and Medium Enterprise (program)</td>
</tr>
<tr>
<td>NATTET</td>
<td>National Association for Technology Transfer and Entrepreneurial Training</td>
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<tr>
<td>PSDS</td>
<td>Private Sector Development Strategy</td>
</tr>
<tr>
<td>RPED</td>
<td>Regional Program for Economic Development</td>
</tr>
<tr>
<td>SME</td>
<td>small and medium enterprise</td>
</tr>
<tr>
<td>SMLE</td>
<td>small, medium, and large enterprise</td>
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<td>SSA</td>
<td>Sub-Saharan Africa</td>
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<td>TFP</td>
<td>total factor productivity</td>
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<td>VAT</td>
<td>value-added tax</td>
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Acknowledgments

This booklet is a shorter version of the Kenya Investment Climate Assessment (ICA) produced in June 2008 by the Finance and Private Sector Development Group of the World Bank’s Africa Region and sponsored by the UK Department for International Development (DFID) Country Office in Kenya. Those interested in more details should read the full ICA report available at www.worldbank.org/afr/aftps.

This book was prepared by Giuseppe Iarossi, but the full ICA report was produced by a larger team that also included Leonardo Garrido, Ricardo Gonçalves, James Habyarimana, Manju Kedia Shah, Sofia Silva, and Måns Söderbom—each having responsibility for different chapters. Numerous other people participated in the completion of the report; their names are listed in the ICA acknowledgments section.

The analysis is based on a survey of 781 establishments. The design of the survey and the management of the data collection process were led by Giuseppe Iarossi and Giovanni Tanzillo. The data collection fieldwork was conducted by Etude Economique Conseil (EEC Canada) from May 2007 through July 2007.

Particular acknowledgments are due to the DFID Country Office in Nairobi for its sustained commitment to, and financial support of, this initiative. Without DFID this major survey work and report would not have been possible.
The central objective of this Investment Climate Assessment (ICA) is to identify the main impediments to productivity growth Kenyan firms face. This objective is achieved through the analysis of firm-level data directly collected by the World Bank in 2007. This report complements the Doing Business indicators and provides a solid analytical foundation for private sector development policy dialogue and design. The last Kenya ICA (2004) indeed served as one of the key analytical tools to inform the government of Kenya (GoK) of its reform efforts during the past few years. It showed that the business environment in Kenya was characterized by poor infrastructure, complex and bureaucratic administrative and regulatory regimes, poor governance, poor service delivery, insecurity, and unsuitable financial instruments.

This ICA arrives at a critical juncture; the government has committed to improving the investment climate, even further convinced that growth can be achieved only through a prosperous private sector. Based on the view that prosperity requires a thriving industrial sector, private sector-led growth is central to the government’s Economic Recovery Strategy and its recent “Vision 2030.” In early 2007 GoK launched its first-ever Private Sector Development Strategy. This strategy is based on five pillars: improving Kenya’s business environment, accelerating institutional transformation, facilitating growth through greater trade expansion, improving
productivity of enterprises, supporting entrepreneurship, and developing small and medium enterprises. All these pillars are linked to the ICA’s analytical goal.

The ICA uses a robust and standardized methodology that has been applied to many countries worldwide. The ICA is based on a representative sample of 657 formal firms and 124 informal establishments. The sample was drawn in four locations—Nairobi, Mombasa, Nakuru, and Kisumu—and covers manufacturing and services. Weights were used in the analysis of the data to ensure full representativeness of the results. Although the sample is quite large, sample nonresponse could invalidate the results of the analysis—especially for more sensitive questions on corruption, taxes, or sales. To reduce such possibilities, strict quality control procedures were applied during the data collection process. These controls led to an overall response rate above 90 percent. The analysis is based on perception questions and objective indicators. Perception questions are used as the starting point of the study, but because of their inherent limitations, throughout the report objective questions are used to confirm or reject what the perception questions appear to indicate. The use of objective questions allows also for more meaningful cross-country comparisons. Consequently, international comparisons are made not only on the basis of perception questions but, more important, on the basis of objective indicators, such as indirect costs and the prevalence of generator use, among others. The use of objective indicators is the preferred approach to identify binding constraints. Finally, data from additional sources (Doing Business, Connecting People, Transparency International) are used to validate the conclusions drawn from the survey results.

Although Kenya has recorded some improvements in the past four years, including an increase in productivity, Kenyan firms still face an adverse business environment. In fact, the total losses incurred by businesses because of power outages, theft and breakage during transport, payments of bribes, and protection payments are much higher than total losses experienced by the middle-income countries in Africa and by China and India.

The top constraints identified by the Kenyan managers were tax rates, access to finance, corruption, security, infrastructure services (electricity and transportation), and business licensing.

In Kenya, complaints about the tax rate top all other constraints; it has been the most reported bottleneck since 2003. Kenya has reduced the corporate tax rates in recent years. Nevertheless, objective indicators of fiscal pressure suggest that the tax burden in Kenya remains higher than...
in most comparator countries. Kenyan firms are still required to pay half their corporate income in taxes, an overall amount that is lower than in China and India, but much higher than in the African comparator countries. The high tax burden faced by Kenyan firms is due mainly to the profit tax rate (32.5 percent), which is the highest of all comparator countries, including China and India. Although a more detailed analysis of the tax burden in Kenya is recommended, one potential impact of a high tax regime is higher evasion, as well as the presence of a larger informal sector. In fact, our analysis shows that one of the top three reasons for informality is the negative perception associated with the tax burden.

Access to credit is significantly more difficult for microenterprises and small enterprises. Consistent with improvements in the banking sector during the past few years, the proportion of firms constrained by access to finance in Kenya declined from 75 percent in 2003 to approximately 36 percent in 2007. Notwithstanding a favorable lending regime with low real costs of debt and a high proportion of firms with good quality information, 90 percent of microenterprises and 60 percent of small firms in Kenya declare they need loans, compared with 40 percent of medium and large firms. Microenterprises are priced out of the market also because of collateral requirements—43 percent of microfirms and 12 percent of small firms, compared with only 7 percent of medium and large firms, report that collateral requirements discouraged loan applications. The complexity of the application process is another impediment for micro- and small firms.

Although the ranking of corruption has improved during the past four years, it remains one of the top bottlenecks for firms in Kenya. In general, because of the various rules and regulations, 75 percent of firms in Kenya reported having to make informal payments to “get things done.” Corruption costs Kenyan firms approximately 4 percent of annual sales, which is a considerable amount by international standards. Furthermore, Kenyan firms are required to pay approximately 12 percent of the value of a public contract in informal payments. That is again higher than all comparator countries. Bribes to tax inspectors are also common in Kenya, as is the request for informal payments for licensing and utility hookups. Finally, one particular aspect of corruption that seems to be unique to Kenya is the common practice of police requesting payments from trucks in transit.

Security remains a major constraint to firms in Kenya. In 2007 approximately one-third of Kenyan managers rated crime as a major constraint. Crime can add significantly to the cost of doing business in Kenya, both
directly through theft and indirectly through security measures used to prevent violence. Overall, these costs amount to approximately 9 percent of sales, which is considerably higher than in all other comparator countries, including South Africa, in which these costs reach only 1.5 percent. These data are based on a survey conducted before the unrest following the 2007 elections. Consequently, these figures must be considered to be conservative because recent conversations with businesspeople in the country have highlighted the lack of security even more.

Electricity and transport are the main infrastructure bottlenecks affecting Kenyan firms. Close to 80 percent of firms in Kenya experience losses because of power interruptions. That percentage is higher than that of all the comparator countries. As a consequence, almost 70 percent of firms have generators, which are costly to obtain and to operate. Power disruption costs Kenyan firms approximately 7 percent of sales. In a cross-country comparison these losses are among the highest. Similarly, Kenyan companies lose 2.6 percent of their sales because of spoilage and theft during transportation. That percentage is higher than that of all comparator countries.

Although Kenya has recently reduced the number of tax payments, tax administration remains a major burden for firms in Kenya. Approximately one-third of firms rate it as a major bottleneck. Approximately 75 percent of firms in Kenya report having been visited by tax officials in 2007. All our comparator countries but China experience a much lower number of visits by tax administration officials. Moreover, the tax filing system in Kenya is cumbersome. Kenyan firms spend about 430 hours in preparing forms and filing and paying taxes. Value-added tax (VAT) refunds, however, are relatively efficient in Kenya.

Notwithstanding recent reforms, business licensing remains an important constraint for Kenyan firms. Approximately 20 percent of managers interviewed place licenses among the top three constraints, and more firms complain about them than in all comparator countries. The Kenyan government has taken this problem seriously, and a number of reforms have been implemented whose effect will be felt in the next few years. Reforms notwithstanding, Kenya does not perform as well as comparator countries in areas such as new business starts, license renewal, and the cost of licenses. Hence the reform program must continue.

Although formalization would facilitate access to finance for informal firms, the financial burden of registration and taxation and the minimum capital requirements to register a business are the main reasons that firms do not choose formality.
To address those constraints, the following recommendations are suggested.

**Taxes**
- Taking into account rebates and fiscal incentives, conduct an in-depth study of the effective marginal rate of taxation to determine the extent of excessive taxation across different sectors.

**Finance**
- Enhance credit information infrastructure.
- Upgrade corporate registries, collateral registries, and public record systems.
- Computerize the property registration process, and simplify taxes and fees.
- Promote the application of innovative products and technology to expand access to finance.
- To promote improvement in small businesses’ access to the products and services of commercial banks, facilitate the provision of capacity building for small businesses to have a better understanding of the requirements of banks (how to approach banks for business loans and how to use bank services), and prepare small businesses for a relationship with a commercial bank.
- Increase transparency in regard to interest rates and noninterest charges and fees (such as negotiation, commitment, legal, evaluation, processing, and insurance) on checking and current accounts.
- Establish a clear timetable for the creation of a credit bureau.
- Facilitate capacity building for banks to develop and market new products.

**Corruption**
- Conduct an in-depth study of corruption in the country.
- Give prosecutorial power to the Anti Corruption Authority, and ensure that the successful anticorruption cases are given better publicity.
- For tax administration, continue reforms aimed at the following:
  - Minimizing human contact between taxpayer and officials and making the process more transparent by relying heavily on information technology to file tax returns
  - Establishing independent internal and external audits
  - Introducing organizational changes of the Revenue Authority: incentives for high performers, sanctions for corrupt behavior, career development, and competitive salaries
• For public procurement, continue reforms aimed at the following:
  – Reviewing procurement rules with the goal of simplifying tender documents, reducing minimum value of contract for single sources, and introducing anticorruption laws, performance standards, and sanctions
  – Improving transparency in public-private interactions through e-procurement, publication of tender documents and tenders received, and public participation in negotiations
  – Introducing a vetting system (conducted by an international firm, possibly with the involvement of civil society) to prequalify companies interested in bidding for government contracts, to address conflict of interests and fraudulent companies
  – Establishing an independent tender evaluation and the auditing and monitoring of unit rates
  – Supporting greater level of integrity and professionalism among multinationals and domestic companies through professional associations, codes of conduct, monitoring and benchmarking, and integrity pacts

• In regard to the police, carry out the following:
  – Have observers join the trucks to monitor the request for bribes. Use recording systems to monitor traveling time and illegal behavior.
  – Establish computerized checkpoints to make the process more transparent and quicker with less interaction between truck drivers and police officials. Educating truck drivers about the automated system will also reduce the harassment they face.
  – Install electronic weighing stations.
  – Involve associations engaged in trucking operations in sensitizing truck drivers to comply with the rules and regulations.
  – Establish an independent police complaints commission entrusted with following up on the implementation of the reform program.
  – Reduce the discretionary power of the police.
  – Conduct effective educational campaigns of traffic rules to reduce ability of police to extort bribes.

• In regard to utilities, carry out the following:
  – Complete the liberalization of fixed-line telephony.
  – Privatize some forms of service delivery (utility hookups).
  – Use citizen report cards to assess the performance and quality of services and monitor progress. Publish progress reports periodically based on customer surveys and timely audits.
Electricity
• Increase public investment in energy generation, transmission, and
distribution to increase connectivity.
• Encourage increased private financing and investment in the energy
sector—today the private sector accounts for 12 percent of the power
supply.
• Establish clear rules for private generators’ “open access” to the trans-
mission network, the concept of which was established in the energy
policy.
• Ensure that electricity pricing maintains the financial viability of
power companies, while protecting the most vulnerable consumers.
• Develop the legal framework for investments in energy.
• Consider using the least-cost development plan to increase invest-
ments in energy.

Transport

Roads
• The Ministry of Finance should establish a system for ensuring proper
investment planning and management. That would, among other
things, involve the following:
  – Issuing guidelines for a minimum level of preparation of projects
    before they are submitted for budget requests
  – Strengthening institutional structure for implementing the guidelines
• Ongoing reforms in the roads sector should be expedited. That would
involve the following:
  – Expediting the operationalization of the Kenya National Highways
    Authority, the Rural Roads Authority, and the Urban Roads Authority
  – Strengthening the residual Ministry of Roads to perform its overall
    policy, planning, and coordination role
  – Promoting the use of long-term output and performance-based con-
    tracting and concessioning for maintenance and management of the
    major road network by the private sector, starting with the Northern
    Corridor
• The government should improve governance in the road sector by car-
rying out the following:
  – Strengthening the Engineers’ Registration Board
  – Assisting the construction industry in establishing a professional body
  – Developing a comprehensive construction industry development
    policy and establishing a dedicated construction industry develop-
    ment board
– Ensuring regular updating of contractors’ qualifications and capacity
– Approving policy on private sector participation in the management
  of weigh stations and control of axle load regulations

• Improvements should be made to the public transportation system.
• More private involvement in transport should be facilitated.

Ports and Maritime
• Expedite conversion of Kenya Ports Authority to a landlord authority.
• Concession the Mombasa container terminal(s), dockyard and marine
  services, and bulk oil terminals.
• Streamline cargo clearance procedures, and remove the police escort
  system for transit cargo by road (except for hazardous and military
  supplies).
• Introduce risk-based targeting for cargo inspection and verification.
• Implement a harmonized customs clearance system and one-stop bor-
  der posts.
• Review and ensure compatibility of local maritime regulations with
  the International Maritime Organization treaties.

Aviation
• Expedite safety and security enhancement at Jomo Kenyatta Interna-
  tional Airport, and strengthen the Kenya Civil Aviation Authority.

Railways
• Expedite putting in place the independent, multisector regulatory
  body, in particular for the railway sector.
• Convert the residual Kenya Railways Corporation into an asset hold-
  ing company that would also monitor and evaluate the performance
  of the concession.

Licensing and Regulatory Governance
• Follow up with the implementation of the licensing reforms.
• Reduce the overall burden of licenses imposed on businesses, includ-
  ing a reduction in time and costs of obtaining a license to undertake
  business operations.
• Continue establishment of an electronic register of licenses.
• Adopt a regulatory reform strategy to serve as a framework for licens-
  ing and other regulatory reforms and to ensure their sustainability.
• Reduce the burden imposed on businesses by on-site inspections.
• Tackle licensing and regulatory reforms at the local government level.
• Introduce a system for vetting proposed regulations to ensure that
  they do not place an undue burden on businesses.
• Reduce the cost of trade documents.
• Reduce the minimum capital requirement to register a company.
• Reduce the costs to start a business.
• Reduce the time taken to start a business.
• Reduce the number of payments for social security contribution and for VAT, and establish online filing as already done in South Africa and Mauritius.
• Harmonize the various tax identification numbers (PIN, VAT, etc.) into one universal number.
• Identify clear responsibilities to continue licensing reforms.
• Improve information and transparency on regulatory reforms and outcomes.
• Reduce time for VAT refund by allowing firms to use it as credit toward next payment.
• Reduce number of licenses by local authority, and clarify the legal status of the “circular.”
Overview

After more than a decade of stagnation, Kenya’s economy shows signs of strengthening, with continued growth in per capita gross domestic product (GDP) at rates of 1.6 percent in 2004, 2.6 percent in 2005, an estimated 2.9 percent in 2006, and an estimated 4 percent in 2007,¹ all in an environment of perceived moderately enhanced macrostability.

From the institutional standpoint, recent growth acceleration in Kenya has been driven largely by the private sector—from the demand side, by private consumption and exports, and from the supply side, by a broad array of activities producing tradable and nontradable goods and services, including horticulture, telecommunication, wholesale and retail trade, manufacturing, and transportation.

All private main economic activities exhibited positive growth during the 2001–05 period, led in overall contribution by agriculture, transport and communication, manufacturing, and wholesale and retail trade, which together explained more than three-quarters (3.1 percentage points) of the private growth during the period (3.9 percent). The private sector generated almost 86 percent of the value added between 2001 and 2005, more than 1 percentage point above its average during the 1990s (figure 1.1).
Nevertheless a growth diagnostics approach shows that the investment rate is low in Kenya for two broad reasons: First, returns on investment are low and risks to appropriation of returns are high; second, access to finance is limited and costs are high for certain categories of borrowers, such as rural and small entrepreneurs. Further, returns on investment are low mainly because business costs—other than the cost of labor and capital—are high. These nonfactor costs take various forms, including high transportation costs and high energy costs. They also include opportunity costs resulting from delays of shipments, as well as direct payments in the form of bribes. The net impact of these nonfactor costs on a business is either reduced sales revenue—and hence reduced profitability and productivity (as measured)—or high total production costs. Macroeconomic and political risks have receded considerably since the 2002 elections, but they remain important. In addition, crime and the security situation remain deterrents to investment.

Having a clearer understanding of the impediments to investment, productivity, and growth at the firm level is essential to pinpoint areas of reform. This report intends to achieve that goal and to provide a solid analytical foundation for private sector development policy dialogue and design. Based on firm-level data on approximately 650 establishments, the Kenya Investment Climate Assessment (ICA) is able to identify key

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**Figure 1.1  Trends in Public and Private GDP Growth/Private Share in Total GDP, 1978–2005**

![Graph showing trends in public and private GDP growth and private share in total GDP from 1978 to 2005.](image)

bottlenecks to enhance the competitiveness of the private sector and to establish links between business environment constraints and firm-level costs and productivity measures.

The previous ICA—based on 2003 data—reported that Kenyan firms had only a weak competitive advantage compared with strategic competitors such as Tanzania and Uganda and were at a severe disadvantage compared with firms in China and India. Kenyan plants and equipment were outdated, overvalued, and inefficiently used; investment levels were low and declining. Productivity growth had been zero or negative since the 1990s. Enterprises were adversely affected by the negative business environment, especially the burden of bribes, the costly infrastructure, and a difficult regulatory environment.

How has Kenyan manufacturing changed during the past four years? How does Kenya now compare regionally and internationally? This chapter addresses those issues by examining data from 396 formal manufacturing enterprises surveyed in mid-2007. This chapter compares performance reported by firms from this survey with establishments interviewed in the previous ICA and benchmarks Kenyan firms to those in other countries.

**Labor Productivity**

Labor productivity is measured by manufacturing value added per worker. Earlier studies of Kenyan manufacturing found that labor productivity in Kenya was comparable with that of China and India and was much higher than that of Tanzania and Uganda. High labor productivity in Kenya, however, was associated with much higher capital intensity compared with firms in China and India. Once we controlled for capital, total factor productivity was lower in Kenya than in East Asia.

The Kenya Institute of Manufacturers conducted its own Economic Survey in 2006. It found that labor productivity, measured as value added per worker in manufacturing, had increased from K Sh 456,000 in 2001 to K Sh 612,347 in 2005—an increase of 34 percent at current prices.

The present survey looks at new data from all four comparators versus Kenya (figure 1.2). Patterns of labor productivity (measured in constant 2005 US$) remain the same across comparators. Kenyan workers are still far more productive than workers in Tanzanian and Ugandan firms (except for large Tanzanian firms, whose productivity is far higher than others). Kenyan firms have productivity only marginally lower than that of firms in China and much higher than that of firms in India.
Examining across firm size, we see that for most countries labor productivity increases with firm size, except in Kenya, in which labor productivity is relatively flat across different size classes. Large firms in Kenya are significantly less productive than firms in Tanzania and only slightly more productive than firms in Uganda.

Differences in labor productivity across sectors are driven primarily by differences in capital intensity. Labor productivity and capital intensity are higher for exporters compared with domestic firms and for foreign enterprises compared with local enterprises. These patterns are similar to those found in other countries; however, unlike in most other countries in sub-Saharan Africa, in Kenya, capital intensity and labor productivity do not change significantly across size classes.

**Unit Labor Costs**

Labor productivity per se cannot be used to benchmark competitiveness. Even though labor has low productivity, as long as workers are paid low wages they remain competitive. We examine this issue by looking at unit labor costs, which measure the ratio of labor costs per worker to value added per worker. Figure 1.3 presents the differences in unit labor costs across the three African countries, China, and India.
We see that unit labor costs in Kenya are lower than in Tanzania and much lower than in Uganda. There is no significant difference across size classes; however, labor cost in Kenya is 25 percent of value added, compared with only 15 percent of value added in China. Higher productivity in China is not offset by higher wages, rendering China very competitive internationally. In India, although labor productivity is low, it is offset by much lower labor costs, making firms in India, particularly the larger ones, more competitive than those in Kenya (figure 1.3).

Labor productivity and unit labor costs, however, are only partial measures of manufacturing competitiveness; they ignore the contribution of capital to the production process. Differences in labor productivity could be driven entirely by differences in the machinery and equipment use per worker. We examine that next by looking at total factor productivity.

**Total Factor Productivity**

Although measures of firm productivity such as labor productivity provide useful information on firm performance, they can be misleading when considered in isolation. To obtain an overall assessment of productivity, it is necessary to take both capital and labor use into account. That can be done by calculating total factor productivity (TFP). Differences in TFP are differences in output that cannot be explained by differences in
the use of labor, capital, and other intermediate inputs. Differences in TFP can be due to the quality of workers, quality of management, technology used (so long as it is not embodied in capital), or firm organization. Firms for which TFP is higher are more efficient.

TFP is calculated by estimating a particular econometric model called the Cobb-Douglas production function using data for enterprises from all manufacturing subsectors. To compare TFP between Kenya and comparator countries, we pool the observations for all comparator countries into a single regression.

The 2003 ICA for Kenya reported that there had been no visible productivity improvement for the average firm between 1999 and 2000 and 2002 and 2003. Regression analysis showed no significant change in TFP between the two periods.

Has this pattern been reversed? Are Kenyan firms more productive today than four years ago? Using the identical methodology to allow comparison with the earlier results, we estimate productivity changes over time by including a time trend dummy with the unbalanced and balanced panel of firms from the 2003 and 2007 surveys. All values have been converted to constant 2005 dollars using the GDP deflator and the average annual exchange rates reported by the International Monetary Fund. Our results show that TFP, measured in value added terms, has increased by 26 percent during the four-year period, indicating an average annual increase of 7 percent.

Results of TFP growth, however, given only one time series component, are sensitive to model specification. Results for a matched panel of firms between 2003 and 2007 show a 23 percent increase in productivity in Kenya during the four-year period. Nevertheless, by simply adding capacity utilization as an additional explanatory variable, the growth rate declines from a 7 percent annual rate to a 4 percent annual rate, and this is no longer significant. These results show that the use of existing capacity (rather than new investments) accounts for the increase in productivity over time.

Further to our analysis, we examine differences jointly in TFP over time and in a broader regional context by pooling data from investment climate surveys over time in Kenya, Tanzania, and Uganda and by adding countries with higher incomes such as Botswana, Namibia, Senegal, and South Africa. Again we see that Kenyan firms have become 15 percent more efficient during this four-year period—an increase of approximately 4 percent annually. We also included middle-income comparators such as Namibia and Botswana and controlled for capital and labor inputs,
sectoral differences, and differences resulting from capital use, measured by capacity utilization. Results showed that enterprises in Kenya are far less productive than firms in Namibia, in which productivity is almost double that of Kenya, and than firms in Botswana, in which firms are 22 percent more efficient than Kenyan firms (figure 1.4).

What explains the lower productivity of Kenyan firms compared with middle-income countries in sub-Saharan Africa? Several factors could drive productivity differentials. The role of an adverse business environment is particularly important in that regard. As shown in the next chapter, our data indicate that enterprises in Kenya continue to face an adverse business climate: Total losses incurred by businesses because of power outages, transport losses resulting from theft and breakage, corruption, and protection payments are much higher compared with middle-income countries in Africa and with China. In Kenya, a substantial part of sales is lost because of these indirect costs, compared with a much smaller percentage in China and India.

Note

CHAPTER 2

Business Climate

Introduction

In 2007 a firm-level survey of approximately 650 formal establishments was conducted in Kenya. During the interview, two types of questions were used to ask firms to identify the major constraints to their business activity. One question asked them to rate a set of approximately 20 potential bottlenecks. Table 2.1 shows the percentage of firms perceiving each constraint as major or very severe. The second question asked the managers to rank the top three bottlenecks to their business among the same list of constraints (table 2.2). The questions show a consistent picture. The top three constraints identified by the Kenyan managers were tax rates, access to finance, and corruption. More than one-third of respondents identified these three as major bottlenecks. They were followed by complaints about infrastructure services (electricity and transportation), crime, and practices of competitors in the informal sector.

Such negative perceptions vary across sector of activity as well as firm characteristics. Both manufacturing and retail complain about tax rates; the manufacturing sector also complains about transportation and electricity, and the retail sector complains about access to finance. A larger share of small firms (compared with medium and large firms) perceived tax rate, access to finance, and practices of competitors in the informal sector to be
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<thead>
<tr>
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</table>

Source: ICA Survey.
severe constraints. Similarly, more firms outside Nairobi indicated these three constraints as binding compared with those in Nairobi. Finally, the share of nonexporters complaining about tax rate and access to finance is higher than that of exporters.

Another way to look at these constraints is to identify which constraints are more problematic for high-performing firms. To examine this issue, we divided firms into two groups: firms above the 75th percentile of labor productivity and of employment growth. Figure 2.1 shows that, for both categories of firms, infrastructure (electricity and transport), tax rates, and competition from informal firms remain the biggest problems, confirming what previous tables indicated.
A similar survey conducted in 2003 enables us to analyze the evolution of these perceptions during the past four years. Table 2.3 shows that in the manufacturing sector, tax rates have been among the top five constraints since 2003; however, today they appear to have become the top constraint. Infrastructure services (electricity and transport) have become more binding constraints in recent years. They moved from the mid-lower part of the rating in 2003 to become the second and third constraints in 2007. In contrast, telecommunications has eased as a constraint and today is among the least problematic. Crime and corruption have improved their ratings, although still remaining among the most pressing problems. Finance was the most important problem for manufacturing firms in 2003 but since then has improved, at least for the manufacturing sector (table 2.3).

During the past four years, the perceived constraints identified by Kenyan firms have changed somewhat. In 2003, manufacturing firms were concerned primarily about finance (mainly cost), corruption, crime, and taxes. In 2007 we recorded an improvement in corruption, whereas tax rates reached the top position of perceived constraints. Similarly, in
Business Climate

2007 we recorded major improvement in macroinstability and telecom, once among the major constraints to Kenyan firms but today no longer an issue (table 2.3).

In a comparison across countries (table 2.4), for all major constraints identified earlier, Kenya performs worse than the best-performing comparator countries (South Africa, China, and India). The only exception is electricity, in which Kenya performs better than China and India. The comparison with the other comparator countries—Senegal, Tanzania, and Uganda—is more mixed, with some bottlenecks perceived to be more of a problem in Kenya and others more problematic in the other countries.

These perceived constraints have a significant impact on indirect costs. Table 2.5 reports the estimated impact of some of these constraints on the indirect costs of firms in Kenya. The survey data show that firms in Kenya have to bear indirect costs that amount to approximately 20 percent of their total sales. Of these, electricity (production lost because of power

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Table 2.3  Kenyan Firms in Manufacturing Sector Reporting Major or Very Severe Constraints, 2007 and 2003

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Rating</th>
<th>2007</th>
<th>Dynamics</th>
<th>Rating</th>
<th>2003</th>
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<td>↓</td>
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<td>Political instability</td>
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<td>↓</td>
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<td>16</td>
<td>9</td>
<td>↓</td>
<td>13</td>
<td>28</td>
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</tbody>
</table>

Source: ICA Survey.
outages) is the main component (7.1 percent of total sales). Crime and bribes are also relevant.

These indirect costs affect different types of firms differently (table 2.5). First, the survey data show that the manufacturing sector is less burdened by these bottlenecks, whereas the retail sector and the rest of the economy bear a higher share of costs (14 percent and 29 percent, respectively). Second, in general, electricity is more of a problem for small domestic firms (8 percent and 7 percent of total sales, respectively) and firms based in Nairobi (8 percent of total sales). Third, bribes affect domestic, small and medium enterprises (SMEs), and nonexporters to a significant extent, whereas crime affects mostly domestic SMEs and firms located in Nairobi. Finally, transport (production lost while in transit) is more of a problem for exporters and firms located in Nairobi.

### Table 2.4 Firms Reporting Major or Very Severe Constraints—International Comparison

<table>
<thead>
<tr>
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Source: ICA Survey.
Table 2.5  Indirect Costs—All Formal Sectors, Kenya, 2007

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<td>5.1</td>
<td>7.3</td>
<td>4.5</td>
<td>7.1</td>
</tr>
<tr>
<td>Bribes</td>
<td>3.6</td>
<td>3.9</td>
<td>3.2</td>
<td>2.0</td>
<td>3.7</td>
<td>2.4</td>
<td>3.7</td>
</tr>
<tr>
<td>Production lost while in transit</td>
<td>2.6</td>
<td>2.0</td>
<td>2.2</td>
<td>3.2</td>
<td>2.9</td>
<td>1.6</td>
<td>0.3</td>
</tr>
<tr>
<td>Theft, robbery, or arson</td>
<td>3.9</td>
<td>3.9</td>
<td>4.6</td>
<td>2.4</td>
<td>4.0</td>
<td>2.2</td>
<td>3.9</td>
</tr>
<tr>
<td>Security</td>
<td>2.9</td>
<td>2.9</td>
<td>3.2</td>
<td>2.7</td>
<td>2.9</td>
<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Total</td>
<td>20.1</td>
<td>20.8</td>
<td>18.4</td>
<td>15.4</td>
<td>20.8</td>
<td>13.7</td>
<td>18.0</td>
</tr>
</tbody>
</table>

Source: ICA Survey.
During the past four years, even these indirect costs have improved. In the manufacturing sector they have decreased from almost 18 percent in 2003 to 14 percent in 2007; however, not all aspects of indirect costs have improved. Although the costs of crime and security have improved, electricity and corruption costs have remained the same and transportation has increased slightly from 1.4 percent to 2 percent (figure 2.2).

From an international point of view, figure 2.3 shows that the level of indirect costs for Kenyan firms is higher than that of all comparator countries. Tanzanian firms bear almost the same level of indirect costs, whereas firms in India, China, and South Africa bear indirect costs that range from slightly more than half to less than one-quarter of those of Kenyan firms. These results appear to confirm the perception that electricity, transport, and crime are significant problems for Kenyan firms.

**Tax Rates**

Businesses worldwide tend to complain about tax levels. Nevertheless, in Kenya, complaints about tax rates top all other constraints. This perception has improved during the past four years, falling from 68 percent of Kenyan firms perceiving it as a major problem in 2003. Nevertheless, Kenya and Uganda are the two countries in the group of comparators with the highest share of firms complaining about tax rates. Kenya's
average is also higher than the average of low-income countries and sub-Saharan African countries (figure 2.4).

In 2007 almost 60 percent of Kenyan managers cited the financial burden of taxation as the most serious obstacle to their operations and growth. This perception is more pronounced among small and large firms, domestically owned firms, or those located outside Nairobi. Statistically, there is no significant difference in this perception between exporting and nonexporting firms.4

Kenya has reduced corporate tax rates in recent years5 by making them more comparable with those of its neighbors in East Africa. Nevertheless, as noted in the World Bank’s Doing Business 2008, objective indicators of fiscal pressure suggest that the tax burden in Kenya is higher than that in most comparator countries. In fact, Kenyan firms are required to pay half (50.9 percent) their corporate income in taxes. This amount is lower than China’s and India’s but much higher than amounts in the other African comparator countries. For instance, South African and Ugandan firms face a tax burden of just 37.1 percent and 32.3 percent, respectively (figure 2.5).

Figure 2.3  Indirect Costs, All Formal Firms—International Comparison

![Indirect Costs, All Formal Firms—International Comparison](image)

Source: ICA Survey.
28 An Assessment of the Investment Climate in Kenya

**Figure 2.4** Firms Reporting Tax Rate as Major or Very Severe Problem

![Bar graph showing the percentage of firms reporting tax rate as a major or very severe problem](image)

*Source: ICA Survey.*

**Figure 2.5** Total Amount of Taxes as Percentage of Profit—International Comparison

![Bar graph showing the total amount of taxes as a percentage of profit](image)

*Source: Doing Business 2007.*
More specifically, the high tax burden faced by Kenyan firms is due mainly to the profit tax rate (32.5 percent), which is the highest rate of all comparator countries, including China and India. The profit tax in China and India is less than 20 percent and in South Africa it is less than 25 percent. Kenya has profit tax rates greater than 7 percentage points than in the major comparator countries. However, labor taxes and contributions in Kenya are lower than in most comparator countries (figure 2.6).

One potential impact of a high tax regime is the presence of a larger informal sector. As shown in chapter 5, one main reason for informality is the negative perception associated with the tax burden. According to the 2006 Kenya economic survey, the informal sector constitutes 72 percent of the working population. The sector has grown by 37.2 percent during the past four years to 6.5 million workers.6

Corruption

Although the ranking of corruption has improved during the past four years, Kenyan firms still place it among the most important constraints to their businesses. Almost one-third of firms ranked corruption among the top three constraints; 38 percent rated it as a major or severe problem. Nearly 70 percent of firms that reported corruption as a binding constraint ranked it as a top constraint.
There appears to be no significant difference in this perception among firms with respect to their size, export orientation, ownership, and legal status; however, complaints about corruption are more pronounced among firms that are located in Nairobi.

From an international point of view, Kenya and Senegal are the two countries in which the perception of corruption is the highest, with almost 40 percent of firms complaining about this problem. Countries such as South Africa, China, and India appear to enjoy a much lower level of corruption, with 16 percent, 27 percent, and 28 percent of firms, respectively, complaining about it (figure 2.7).

Results of the present survey are confirmed by other data sources. Both the Transparency International corruption perception index and the World Bank governance indicators show an improvement in Kenya’s rating during the past few years (figure 2.8). Nevertheless, Kenya’s corruption rating remains the worst among all comparator countries (figure 2.9). In 2007 Kenya’s rank in the corruption perception index was 150th of 180 countries surveyed.

Corruption takes many different forms, from making payments for utility hookups to informal payments in public procurement. In general, three-fourths of Kenyan firms reported having to make informal payments to “get things done” with rules and regulations. This costs
Kenyan firms approximately 4 percent of annual sales. By international standards, this is a considerable amount. Firms in comparator countries face a lower level of informal payments, with firms in China, India, and South Africa paying less than half that amount.

The survey data allow us to identify the many aspects of a business that create opportunity for illegal payments. Firms were asked how much
they were supposed to pay as informal payments in public procurement. The answers provided by Kenyan managers show a staggering difference between Kenya and the other comparator countries. Kenyan firms are required to pay approximately 12 percent of the value of a public contract as informal payments. That is higher than in all comparator countries (figure 2.10).

Bribes to tax inspectors are also common in Kenya. Corruption in the revenue authority is common knowledge in Kenya. The commissioner general said that in 2008 tax revenues will increase in part as a result of his crackdown on “leakages.” According to the survey data one-third of sampled firms reported having tax inspectors request informal payments. That figure is high by international standards. With the exception of India, Kenya fares worse than all other comparator countries (figure 2.11).

The frequency of inspections seems to be correlated with bribe requests from tax inspectors. The more often firms are visited, the more likely they are to be asked for informal payments. Similarly, firms that admit paying the tax inspectors also declare approximately 3 percent to 8 percent fewer sales for tax purposes.

Licensing represents yet another opportunity for informal payment requests. Kenyan firms are required not only to obtain licenses when they start operation, but also to renew them yearly. Virtually all firms in Kenya are required to renew licenses and permits periodically; however, although

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**Figure 2.10  Bribes in Public Procurement**

![Bar chart showing bribes in public procurement across different countries.](image)

*Source: ICA Survey.*
about one-third need to renew licenses with the central government, almost all firms in Kenya need to periodically renew licenses with the local government (figure 2.12). When dealing with licenses, Kenyan firms are asked for informal payments approximately one-quarter of the time.
Informal payments might also occur when utility hookups are requested. In fact, one-quarter of Kenyan firms requesting utility hookups declared they have been asked for informal payments. Overall, such payments appear to be more frequent with construction permits and water hookups and least common with electricity connections and import licenses (figure 2.13).

One particular aspect of corruption that appears to be unique to Kenya is the common practice of police requesting payments from trucks in transit. The survey questionnaire asked managers to indicate to what extent this practice was common. Although not widespread, this phenomenon is significant, with 21 percent of firms reporting having to make such payments. The average amount paid is approximately 2.5 percent of sales and is borne more by the service sector than by the manufacturing industry.

Finally, another often forgotten aspect of corruption relates to the functioning of the courts. If we look at general perceptions, it appears that only 13 percent of firms consider the functioning of the court a problem. Hence, it might appear to be an issue that does not need to be addressed; however, if we estimate the perception among firms that had a dispute over payment and used the courts to solve it, the share of managers concerned about the functioning of the courts rises to 33 percent, on a par with crime and tax administration. Furthermore, discontent about the functioning of the courts is quite widespread. Although most firms admit

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Figure 2.13  Bribes, Licenses, and Utilities: Percentage of Firms from Which Informal Payments Are Requested When They Apply for Licenses and Utilities

![Bar chart showing the percentage of firms from which informal payments are requested when applying for various licenses and utilities.](source: ICA Survey)
that court decisions are generally enforced, fewer than one-quarter of firms consider the Kenyan courts fair, impartial, and uncorrupted; an even smaller number consider them fast (figure 2.14).

The *Doing Business* indicators confirm our conclusions by showing that the number of court procedures in Kenya is among the highest and that the cost of court proceedings is also quite significant with respect to many of our comparator countries (figure 2.15). Related to the functioning of the courts is the procedure for closing a business. Even in this case, the *Doing Business* indicators show that the cost and the timing of such procedures in Kenya are among the highest. In Kenya it takes more than four years to close a business (second only to India, where courts are notoriously slow), and the cost of such procedures amounts to approximately 22 percent of the value of the estate (figure 2.16).

**Electricity**

Findings from earlier firm-level surveys have highlighted the importance of a reliable power supply. For different reasons—strong economic growth in some places, economic collapse in others, war, poor planning, population booms, high oil prices, and drought—sub-Saharan nations face crippling electricity shortages. And yet Kenyan firms do not indicate power as a major constraint, although 85 percent of them report experiencing power outages. This apparent contradiction is explained by

![Figure 2.14  Courts Malfunctioning: Percentage of Firms That Consider the Court System Efficient](image)

*Source: ICA Survey.*
the fact that two out of three firms own a generator. Hence, although only 28 percent complain about electricity, 31 percent do not complain because they have their own power supply. From a policy standpoint, however, we need to consider those with a generator as firms complaining about electricity. If we do that, then electricity rises as one of the top problems facing Kenyan firms in 2007.
With the recent growth of the Kenyan economy, electricity consumption has been growing at a steady pace, reaching a growth rate of 5 percent in 2006. Henceforth, it is not surprising to note that during the past four years electricity has become more of a problem than it used to be. In fact, although in 2003 only 48 percent of manufacturing firms complained about this problem, 53 percent of manufacturing firms did so in 2007, ranking this as the third most important bottleneck.

Additional survey evidence shows how serious the problem of power is. Close to 80 percent of firms in Kenya experience losses resulting from power interruptions. This is the highest value of all comparator countries, along with Uganda (figure 2.17). In China, only 40 percent of firms report losses resulting from power outages, and in South Africa even less do so (13 percent).

Furthermore, Kenyan firms experienced approximately eight power outages per month in 2007, each lasting approximately 4.5 hours. Hence, firms in Kenya lost on average the equivalent of approximately four days of production a month because of power outages. Given the dimension of such a problem, two out of three firms in Kenya own or share a generator and use it for 16 percent of their electricity needs (table 2.6). Among all comparator countries, Kenya is the country with the highest share of firms owning a generator (table 2.7).

Owning a generator is, however, costly. Not only is it more expensive to generate electricity, but the capital investment of a generator accounts for approximately 3 percent to 5 percent of the total value of machinery.

Figure 2.17  Percentage of Firms That Experienced Sales Losses from Electrical Outages

Source: ICA Survey.
### Table 2.6  Frequency and Duration of Power Outages and Power Generator Ownership in Kenya

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Total</th>
<th>Manuf</th>
<th>Retail</th>
<th>Residual</th>
<th>Small</th>
<th>Medium</th>
<th>Large</th>
<th>Dom</th>
<th>For</th>
<th>Out Nairobi</th>
<th>Nairobi</th>
<th>Nonexporter</th>
<th>Exporter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of firms that experienced outage</td>
<td>84</td>
<td>92</td>
<td>81</td>
<td>84</td>
<td>84</td>
<td>84</td>
<td>89</td>
<td>85</td>
<td>80</td>
<td>77</td>
<td>89</td>
<td>83</td>
<td>95</td>
</tr>
<tr>
<td>Share of firms with own generator</td>
<td>66</td>
<td>66</td>
<td>n/a</td>
<td>n/a</td>
<td>34</td>
<td>67</td>
<td>91</td>
<td>63</td>
<td>79</td>
<td>69</td>
<td>65</td>
<td>56</td>
<td>84</td>
</tr>
<tr>
<td>Percentage of electricity from own or shared generator</td>
<td>16</td>
<td>16</td>
<td>n/a</td>
<td>n/a</td>
<td>18</td>
<td>15</td>
<td>16</td>
<td>16</td>
<td>16</td>
<td>14</td>
<td>17</td>
<td>16</td>
<td>16</td>
</tr>
<tr>
<td>Average duration of outages per month (in hours)</td>
<td>33</td>
<td>31</td>
<td>27</td>
<td>39</td>
<td>35</td>
<td>29</td>
<td>29</td>
<td>33</td>
<td>36</td>
<td>36</td>
<td>32</td>
<td>33</td>
<td>37</td>
</tr>
</tbody>
</table>

*Source: ICA Survey.*
and equipment. That explains why generators are owned mainly by medium-size and large firms.

The impact of unreliable power supply on production costs is not limited to the generation of electricity. As we saw earlier, Kenyan firms suffered a 7 percent loss in sales because of power disruption. Small domestic firms are more affected by such disruptions. Nairobi-based firms report higher costs.

From an international perspective, the losses suffered by Kenyan firms are among the highest, and they are the greatest component of all indirect costs considered. Chinese and South African firms enjoy a much lower level of such losses (figure 2.18).

Obtaining a power connection is still a lengthy process in Kenya. One-quarter of sampled firms requested a connection within the past 2 years, and it took them 40 days to obtain it. That is double the time it takes firms in China and India and more than six times the time it takes in South Africa (figure 2.19). Firms that were asked to make informal payments to set up an electric connection report a longer period of time to receive it—79 days. The waiting time is even longer outside Nairobi.

**Transportation and Customs**

A country’s ability to efficiently connect firms, suppliers, and consumers to global supply chains is essential to its competitiveness. By using seven measures of performance, a recent assessment of the logistics gap across countries\(^{10}\) ranked Kenya 76th of 150 economies, well behind South Africa (ranked 24th), China (30th), and India (39th). Survey respondents

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Kenya</th>
<th>India</th>
<th>Senegal</th>
<th>South Africa</th>
<th>Tanzania</th>
<th>Uganda</th>
<th>China</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of firms with own generator</td>
<td>66</td>
<td>52</td>
<td>62</td>
<td>9</td>
<td>42</td>
<td>25</td>
<td>18</td>
</tr>
<tr>
<td>Percentage of electricity from own or shared generator</td>
<td>16</td>
<td>22</td>
<td>7</td>
<td>0</td>
<td>16</td>
<td>8</td>
<td>2</td>
</tr>
<tr>
<td>Average duration of outages per month (in hours)</td>
<td>33</td>
<td>27</td>
<td>24</td>
<td>2</td>
<td>88</td>
<td>106</td>
<td>n/a</td>
</tr>
</tbody>
</table>

Source: ICA Survey.
identified transportation and electricity as the two leading infrastructure constraints to doing business in Kenya. Thirty-one percent of firms rated transportation as a major bottleneck, and one-quarter of respondents ranked it as one of the top three constraints. Unsurprisingly, firms outside Nairobi perceived it to be a major problem more often than did firms
located in the capital city. Particularly worried about the status of the transportation system is the manufacturing sector. More than 60 percent of manufacturing firms transport their own goods, and in 2007 more than half reported transportation as a major problem, up from only 37 percent in 2003.

Supply chain problems often result in firms holding large inventories, which represent an additional cost for firms. Figure 2.20 shows that firms in Kenya hold on average 17 days of production in stocks of their most important input. Although that is not high compared with other countries, inventory holdings for manufacturing enterprises in Kenya are much higher, with an average of 47 days. That is among the highest of all comparator countries (figure 2.20).

Kenyan firms bear high direct and indirect costs because of the quality of the transportation infrastructure. Inland transport costs in Kenya are much higher than in China and India—where they are just a fraction of the costs in Kenya—and they are among the highest of all comparator countries. As shown in figure 2.21, shipping a 40-foot container costs Kenyan firms much more than it costs firms in all other comparator countries, except Uganda.

Unfortunately, when we look at losses from transportation-related problems, Kenya does not perform any better. Kenyan companies lose 2.6 percent of their sales to spoilage and theft during transportation. That is the highest value of all comparator countries. China, India, and South Africa lose half that amount (figure 2.22).  

\[\text{Figure 2.20  Inventory Holdings—International Comparison}\]

![Inventory Holdings—International Comparison](source: ICA Survey.)
The losses presented previously affect different types of firms differently. Losses during transportation affect more large firms, exporters, and firms located in Nairobi (figure 2.23).

Half the transportation losses reported by Kenyan firms are due to transport delays, and the other half are due to theft during transportation. Crime, hence, is also a problem when transporting goods. As we saw earlier, firms in Kenya admit to paying police when transporting goods. More specifically, 21 percent of them do so (25 percent of manufacturing firms). On average, they pay the equivalent of 1 percent of sales. These payments appear to protect firms from delays. Firms that admit...
they provide informal payments, in fact report a shorter time to reach Mombasa from Nairobi (three hours or less).\textsuperscript{12}

Another aspect of transportation not captured by the previously mentioned losses is the time it takes to transport goods within Kenya. Surveyed firms were asked to estimate how long it takes to ship goods from their cities to Nairobi, Mombassa, Nakuru, and Kisumu. Firms reported that it takes approximately 14 hours from Nairobi to Mombasa, 4 hours
between Nairobi and Nakuru, and another 4 hours from Nakuru to
Kisumu. Furthermore, more than 10 percent of the travel time is lost
between Nairobi and Mombasa because of weigh bridges, roadblocks, and
other control posts. These delays are a little shorter if trucks are directed
to Nakuru from Nairobi (8 percent) and much less if directed to Kisumu
from Nakuru (2 percent).

Finally, clearing customs is also expensive. Customs costs in Kenya—
represented by customs clearance and ports handling—are approximately
US$500 (US$550 for exports), almost double the cost in South Africa
and India and three times as much as in China (figure 2.24).

Crime
Crime remains common in Kenya. The Kenya Human Rights Network
said that in the first six months of 2007 approximately 300 murders were
committed in Kenya. For some observers the surge in criminal activity
is linked to elections. It is true that Kenya has suffered cyclical violence
each election year since 1992, when it became a multiparty democracy.

Regardless of its cause, crime remains a major problem for Kenya’s
private sector. Although the perception of crime has improved during
the past few years—in 2003 almost 70 percent of manufacturing firms
complained about it—by mid-2008 approximately one-third of Kenyan
firms rated crime as a major constraint. That is, nevertheless, even higher
than in South Africa, notoriously known for this problem, and much
higher than all comparator countries (figure 2.25). China and India enjoy a much lower level of crime, with 20 percent and 9 percent of firms complaining about it, respectively.

Concerns about crime vary across firms. Compared with small firms, medium-size and large firms are significantly more likely to report crime as a severe constraint. Surprisingly, firms in Nairobi are less likely than those located in other cities to perceive crime as severe. Finally, manufacturing firms complain more about crime than do firms in the other activity sectors.14

When we look at more objective indicators of crime, the picture is the same. Although objective measures of crime are hard to obtain, the survey asked a number of questions related to crime. The data show that crime can add significantly to the costs of doing business in Kenya, both directly through theft and indirectly through security measures and protection payments extended to organized crime to prevent violence.

As indicated in figure 2.26, Kenyan firms reported losses from crime averaging almost 4 percent of annual sales. These costs are significantly higher than costs experienced by firms in all other comparator countries, including South Africa, in which losses were less than 1 percent. Similarly, in China and India objective cost data show much lower losses (one-tenth the cost experienced by Kenyan firms).

Similar results are obtained if we look at the indirect costs resulting from the installation of security measures on the business premises. In Kenya, about three-quarters of firms incurred extra costs to pay for security

Figure 2.25  Percentage of Firms Reporting Crime as a Major or Very Severe Obstacle to Business—International Comparison

![Percentage of Firms Reporting Crime as a Major or Very Severe Obstacle to Business—International Comparison](chart.png)
services (equipment, personnel, or professional security services) or to make protection payments to organized crime. That is the highest of all comparator countries except South Africa, in which 80 percent of firms had security systems installed. As in the case of direct costs, Kenya spends more on crime prevention measures than do all other comparator countries (figure 2.27). Kenyan firms spend an average of 2.9 percent of sales each year on security services, whereas China and India spend just 0.8 percent and 1.2 percent, respectively. Only Tanzanian firms come close to Kenyan firms, with 2.3 percent of sales spent on security. In addition to the cost of security, firms in Kenya also make informal payments to organized crime to prevent theft and arson. Here once more, Kenya leads with almost 1 percent of sales paid, much higher than in all other comparator countries.

If we add the cost of criminal acts (theft and arson) and the cost of security services (both legal and illegal), we can see that Kenyan firms do indeed face a much higher crime cost than all other comparator countries. The total impact on production costs is approximately 8 percent of sales (7 percent if protection payments to organized crime are excluded), which is considerably higher than in all comparator countries, including South Africa (in which the total impact reaches only 1.5 percent) (figure 2.28).

The security situation in Kenya, therefore, has a significant impact on business decisions. In fact, 60 percent of firms responded that their hours of operation are affected by this constraint, mostly manufacturing and retail. Approximately 45 percent reported that their transport of goods is affected—mainly in the manufacturing sector—and 40 percent said that
their investment decisions are affected by crime (10 percent to a significant extent) (figure 2.29). All this evidence leads us to conclude that crime has a significant cost implication for Kenyan firms, and therefore it remains a major constraint.
Tax Administration

Despite recent reforms that have reduced the number of tax payments, tax administration remains a major burden for firms in Kenya. Approximately one-third of firms rated it as a major bottleneck, and 15 percent ranked it among the top three problems. Manufacturing firms complain much more, with approximately 43 percent rating it as a major bottleneck in 2007. That is lower than those complaining in 2003 (53 percent) as a result of the reduction in the number of payments and the decrease in the average number of visits made by tax officials. Nevertheless, manufacturing firms still complain a great deal about tax administration. Across firms, small and large establishments complain more, as well as firms outside Nairobi.

Three out of four firms in Kenya report having been visited by tax officials in 2007. On average, they are visited once a month. There is, however, a wide variation among firms. Small firms receive more visits than medium-size and large firms. Small firms report more than one visit a month, whereas medium-size establishments are visited once a month, and large companies once every quarter. This seems justified because small firms in fact declare some 65 percent of sales for tax purposes, whereas medium-size and large firms are more tax obedient (with 80 percent and 85 percent declared, respectively). In 2003 large firms were visited more often than small establishments. The number of visits, however, is not
related to the amount of sales declared for tax purposes, but the payment of bribes is significantly correlated with higher tax evasion.\textsuperscript{15}

International comparisons appear to confirm Kenyan firms’ perception. All our comparator countries but China experience a much lower number of visits by tax administration officials (figure 2.30).

The tax filing system in Kenya is cumbersome. According to the \textit{Doing Business} indicators, Kenyan firms spend about 430 hours to prepare forms, file, and pay taxes (figure 2.31). In addition, establishments need to make 41 tax payments a year to the revenue authority, whereas in South Africa firms need to make only 11 payments, and they spend 25 percent less time.

Value-added tax refunds, however, are relatively efficient in Kenya. Most firms report receiving the refund within 60 days of submitting the application; however, for the rest of the firms it takes much longer, with 30 percent reporting having to wait up to one year, and the remaining 10 percent more than one year.

\section*{Business Licensing and Permits}

Although only 20 percent of managers interviewed place licensing among the top three constraints, it remains an aspect of the business environment in which the government must continue its reform efforts. In fact,
additional survey data show that licensing remains a significant problem for firms in Kenya. First, as shown above, corruption in obtaining licenses is common in Kenya, with 25 percent of firms admitting having to pay illegal payments in such instances. Hence, it is possible that respondents discounted licensing as a problem because they had already identified it as such in the corruption question. Second, from an international perspective, more firms in Kenya complain about business licensing today (28 percent) than in all other comparator countries, with small and large firms as well as foreign firms complaining more (figure 2.32). Finally, during the past four years Kenyan firms have perceived this constraint as more binding, moving from 15 percent of firms complaining about it in 2003 to 28 percent in 2007.¹⁶

The Kenyan government has recognized the importance of this aspect, and a number of reforms directed at reducing the number of licenses have been approved in 2006. The reform program has eliminated 110 business licenses and cut the time and the cost of obtaining building permits. The still-ongoing program will eventually eliminate or simplify at least 900 more of the country’s 1,300 licenses. This program might appear to stand in contrast with firms’ perception of the severity of the licensing constraint. However, that is not the case because the survey data were collected at the same time these reforms were being implemented; hence the available data are unable to reflect the impact of these reforms.
The Kenyan government has made substantial achievements in licensing, as proved by Kenya’s appearance among the top 10 worldwide reformers in 2007, according to the *Doing Business* indicators. As an example, since 2005 Kenya has been able to improve both the time (by 30 percent) and the cost to deal with construction licenses (by 20 percent). In 2008, Kenya became the best performer among our comparator countries in the number of procedures required and the time taken to deal with licenses and their cost (figure 2.33).

The positive impact of these reforms is also reflected in the amount of time managers need to spend in dealing with requirements imposed by government regulations. Although in 2003 managers had to dedicate approximately 14 percent of their time to this task, in 2007 they spent approximately half that. By an international comparison, Kenya is much better than most of our comparator countries (figure 2.34).

Reforms notwithstanding, there are other areas of the business environment related to business licensing in which Kenya does not perform as well as the other comparator countries. For instance, starting a business in Kenya remains a lengthy process. Kenya is second only to Senegal in the number of days required to start a new activity, with China, India, and South Africa requiring approximately one-third less time. The problem is not in the number of procedures necessary to follow, an area in which Kenya performs relatively well. The bottleneck appears to be in the actual processing time. Similarly, the cost of these procedures is also relatively high when compared with both China and South Africa (figure 2.35).

In addition to obtaining a license, renewing it is an area in which there is room for improvement. Most firms interviewed during the
survey said that they needed to renew licenses (up to three) from the local government periodically. Although on average it takes about 18 days to obtain a domestic business license and 43 days to obtain an expatriate license, the great majority of firms can obtain a license in a month. Nevertheless, the processing time to renew licenses is much
longer for a significant number of Kenyan firms. In fact, although most firms (60 percent) obtain a renewal in up to one month, for the other 40 percent it might take as long as one year. That pattern is the same for local and central government licensing agencies (figure 2.36).
Finally, some licenses in Kenya are more expensive than in other countries. More specifically, the cost to prepare trade documents is the highest of all comparator countries (figure 2.37).

Approximately one-quarter of firms in Kenya use facilitators to deal with licenses. Medium-size and large firms use them more than do small firms. On average, it costs small firms about half a percentage point of
sales to use facilitators, with medium-size and large firms paying less than do small firms (figure 2.38).

Notes

1. All results are weighted.
2. The survey in 2003 covered only manufacturing firms; hence, comparisons across time refer only to that sector.
4. The difference in perception across firm characteristics is estimated with a probit model with robust standard error. The result of the empirical relationship is presented in the appendix in the full ICA report.
5. Deloitte & Touche.
11. This value refers to exports.
12. The number of observations are too few to be able to estimate this value for the other cities.
14. See appendix in the full ICA report for a complete set of regression results.
15. See more in the section on corruption.
16. Recall that because in 2003 the sample was composed only of manufacturing firms, every panel comparison refers to manufacturing firms only.
Access to Finance from an International Perspective

Enterprise development requires the availability of external financing to bridge the gap between internally generated resources and the financing needs of dynamic firms. We begin this chapter by examining firm perceptions of the cost and availability of external finance. We then turn to objective measures of the availability and cost of external financing.

About 36 percent of small, medium, and large enterprises (SMLEs) and 76 percent of microenterprises in the manufacturing sector in Kenya rated access to and cost of finance as a major or severe obstacle (figure 3.1).

In addition, a higher proportion of formal nonmanufacturing firms report finance as a major or severe impediment to firm operation and growth: 48 percent of retail firms and 41 percent of services firms.

Although cross-country comparisons of perceptions data are difficult to make, it is instructive to examine perceptions of the external financing regime in Kenya relative to a set of comparators. Figure 3.1 shows that relative to middle-income South Africa and the fast-growing economies of China and India, a higher proportion of manufacturing firms in Kenya report access to and cost of financing as a major or severe impediment to operation. Only about 10 percent of SMLEs in the manufacturing sector rated access to finance as a serious concern in South Africa.
The corresponding estimates are 23 percent and 15 percent for China and India, respectively. The comparison with the other African comparators, however, is more favorable and consistent with a number of other studies on the Kenyan banking sector: 41 percent of firms in Tanzania, 55 percent in Senegal, and 60 percent of firms in Uganda report being constrained by poor access to finance. A potential concern with a comparison of national averages is that differences in the composition of manufacturing sectors across the comparator countries drive the differences in perceptions that we observe. We obtain the same ranking of countries, however, when we restrict the comparison only to firms in the garment and textile subsectors.

A similar picture emerges when microenterprises are compared in Figure 3.1. Only 27 percent of microfirms in South Africa report that their growth is impeded by the lack of access to finance, compared with nearly three times that fraction in Kenya. Access to external financing for microfirms appears more favorable in the less developed private sector of Tanzania, in which only 46 percent of firms report access to finance as a major or severe impediment. In Uganda, however, the proportion of microfirms that report being constrained by the lack of availability and cost of finance is similar to that in Kenya.

How much have perceptions changed during the past three years in Kenya, and to what extent are changes related to shifts in the external

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**Figure 3.1** Percentage of Manufacturing Enterprises Reporting Finance as a Serious Impediment to Operation, by Size—International Comparison

![Figure 3.1](image-url)

*Source:* ICA survey.

*Note:* Cross-country comparisons are only for manufacturing enterprises.
finance regime? Using data from the 2003 and 2007 surveys, we restrict the analysis to a set of firms surveyed in each year. This addresses concerns that differences in perceptions across the two survey periods are driven by differences in sample composition. A total of 75 percent of these firms reported being constrained by access to finance in 2003. In 2007, only 36 percent of the same set of firms reported access to finance as a major or severe impediment. The decline in the proportion of firms constrained by access to finance is large (a 40 percent decline) and suggests a significant improvement in the external financing regime.

The decline in firm perceptions is consistent with changes in the performance of the banking sector during the past five years (Kenya: Acceleration and Sustaining Inclusive Growth, World Bank 2008). First, improvements in fiscal management during the past five years induced a shift out of government securities and into credit to the private sector. Consequently, increased competition in the banking sector has led to a large expansion in credit to the private sector. The subsequent decline in the nominal cost of borrowing underlines the effects of improved fiscal management and competition in the banking sector. An examination of Figure 3.2 confirms a decline in the weighted average cost of short- and long-term finance by almost 5 percentage points across the two survey years. The decline in the nominal cost of borrowing is reinforced by rising inflation between 2003 and 2007, suggesting an even larger decline in the real cost of borrowing.

**Figure 3.2  Annual Cost of Borrowing**

Source: Central Bank of Kenya.
Although firm perceptions are informative indicators of problems in the financing regime, they do not provide a sufficient description of the external financing opportunities available to firms. For that we turn to objective measures of the type and range of financing options.\footnote{An Assessment of the Investment Climate in Kenya}

A total of 73 percent of formal manufacturing firms in Kenya (SMLEs from here on) have access to at least one credit product (overdraft, line of credit, or a loan). That is considerably higher than in both Tanzania (33 percent) and Uganda (23 percent) but the same as in South Africa (75 percent).

Predictably, only a small fraction of microenterprises report having any type of bank credit. A total of 22 percent of microenterprises had a loan, credit line, or overdraft. That is slightly higher than in Tanzania (19 percent) and considerably higher than in Uganda (12 percent). So although the same proportion of firms in Kenya and Uganda report being impeded by access to and the cost of finance, a microfirm in Kenya is twice as likely as a microfirm in Uganda to have access to bank debt. The lower reports of perceptions in Tanzania potentially reflect lower demand for bank debt relative to its East African neighbors.

In addition to the basic data on whether firms have loans, firms are also asked about how they finance working capital and long-term investment requirements. On average, manufacturing firms in Kenya finance 51 percent of working capital and 59 percent of new investments with retained earnings. That is considerably lower than in all other African comparators. Perhaps surprisingly, firms in Kenya finance a lower proportion of working capital requirements out of retained earnings than firms in South Africa, and about the same proportion as firms in India (figure 3.3).

Although firms are not heavily dependent on retained earnings for financing working capital, the use of bank debt is moderate. The average SMLE financed about 14 percent of working capital with bank financing; that is a slightly lower percentage than in South Africa. Although the bank debt share of working capital needs in Kenya is higher than in the other East African countries (Tanzania 8 percent and Uganda 6 percent), it is only about half the level of the proportion financed by banks in India.

What makes up the gap in working capital financing is the use of trade credit. A total of 31 percent of the working capital needs of Kenyan firms are financed by trade credit. Trade credit is the leading source of working capital external to the firm. The share of working capital financed by trade credit in Kenya is higher than in any of the other comparator countries. Trade credit contributes only 12 percent and 9 percent of working capital requirements in South Africa and India, respectively. Even in the other
East African neighboring countries, Tanzania and Uganda, in which bank debt is less accessible, trade credit accounts for only 20 percent of working capital requirements. The use of trade credit in Senegal is considerably lower: only 5 percent of working capital needs are financed by trade credit.

The foregoing suggests that relationships between firms in Kenya support a considerably high level of working capital financing that is cheaper than bank debt. Although the nature of these dense firm-firm relationships might be difficult to replicate between banks and firms, this represents a profitable niche that can be served by an expanding and improving banking sector.

Looking at longer-term financing, firms in Kenya finance a lower share of their investment with retained earnings than the other African comparator countries do. The average firm in Kenya finances about 59 percent of its new investment with retained earnings. This is comparable to the corresponding share in South Africa and lower than Senegal (67 percent), Tanzania (80 percent), and Uganda (80 percent). In comparison, the typical firm in India finances just over 50 percent of new investment with retained earnings.

Firms in Kenya use bank financing more intensively than do firms in the comparator countries to finance new investments. More than 30 percent of new investments in Kenya are financed by bank debt, compared with

---

**Figure 3.3  Sources of Finance for Working Capital—International Comparison, Manufacturing Sector**

![Graph showing sources of finance for working capital](image)

*Source:* ICA survey.

*Note:* The data for China were incompatible with Kenya data.
only 5 percent in Tanzania and Uganda and 15 percent to 20 percent in Senegal, South Africa, and India (figure 3.4).

It is instructive to explore some explanations for the more extensive use of bank financing in Kenya. Below we elaborate on two plausible demand-side explanatory variables: the cost of debt and the quality of information for assessing debt applications.5

An important determinant for the demand for bank debt is the real cost of borrowing. Although the cost of a Kenya shilling borrowed includes a variety of costs other than interest, we have data only on the interest cost of borrowing. As recent survey evidence has shown, however, noninterest charges and fees constitute a considerable share of the cost of borrowing. These charges include negotiation, commitment, legal, valuation, processing, and insurance fees. Data on each of these potential loan fees were not collected as part of this survey, but much of the scanty evidence suggests that interest costs account for the principal share of the cost of finance.

As figure 3.5 demonstrates, the real interest rate facing borrowers plays an important role in explaining the intensive use of debt financing in Kenya. Median real interest rates are the second lowest among comparator countries, with only Chinese firms facing lower real costs of borrowing.6

A second determinant of financing is the quality of information that firms produce and maintain. Information that can be reliably used to

![Figure 3.4 Sources of Finance for New Investments—International Comparison, Manufacturing Sector](source: ICA survey)
evaluate financing propositions makes banks more willing to lend. An examination of the prevalence of externally audited accounts is a good measure of the quality of information produced by firms. A total of 88 percent of manufacturing firms in Kenya produce audited financial...
statements. That is considerably higher than in the two East African neighbors, Tanzania (58 percent) and Uganda (44 percent), but lower than in South Africa (97 percent). Only 70 percent of firms in Senegal and 84 percent in India produce reliable information by this metric. The overall quality of the information produced by firms in Kenya contributes to the favorable finance regime represented by the factors presented previously.

Another important determinant of the demand for financing is the amount of collateral required to secure a loan. Almost 90 percent of firms with loans were required to post collateral. That percentage is among the highest of all comparator countries (figure 3.6). The average value of collateral requirements, however, is 110 percent of loan value. The average collateral-loan ratio is considerably low compared with that of other countries and is lower than the average reported in 2003 (175 percent against 125 percent\textsuperscript{7} in 2007). The frequently used form of collateral is machinery and equipment. A total of 60 percent of borrowing firms posted machinery and equipment as collateral. Land and buildings are the next most frequently used form of collateral and were posted by more than 50 percent of secured debtors. Accounts receivable and inventories are also often accepted as collateral, with more than 45 percent of firms posting them. The use of personal assets, however, represents only 28 percent of collateral posted. Unlike in its East African neighbors, in which the most frequently used collateral requirements are lumpy assets such as land and

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure3_6.png}
\caption{Collateral Requirements—International Comparison}
\end{figure}

\textit{Source:} ICA survey.
buildings, in Kenya movable assets and receivables are used, an important indicator of Kenya’s financial market development and sophistication.

Finally, we examine one aspect of the terms under which credit is extended: the duration of the loan. Ideally, a firm would like to match the cash flows from its investments with loan repayment obligations. For investments with long payback periods, firms would generally prefer longer loan durations. Although we are unable to show the desired length of loan terms from the firm’s perspective, we can show the actual duration for the loans in the sample. Figure 3.5 illustrates that the median duration of loans in Kenya is in the middle of the pack of comparator countries. The typical loan in Kenya has a term of three years compared with four years in Senegal, and five years in India and South Africa. Compared with its East African neighbors, in Kenya loan duration terms appear considerably more favorable.

Despite nearly 40 percent of firms reporting major or severe impediments to growth as a result of poor access to finance, the cross-country comparisons paint a much more favorable picture of the finance regime for firms in Kenya. It is underpinned by low real-interest costs of borrowing and the good quality of information firms produce. Compared with firms in their East African neighbors, Kenyan firms enjoy a superior advantage in access to finance. Although Kenyan firms use as much if not more bank debt as in India and South Africa, they face shorter loan durations.

**Effect of Firm Size on Access to Credit**

Having shown that aggregate measures of access to credit in Kenya are relatively good, we examine in more detail variation in access to credit within Kenya. Essentially, we ask how firm characteristics affect the likelihood of access to finance. In this section, we also examine the relative prospects of formal nonmanufacturing firms in the retail sector and other service sectors with respect to the financing regime.

Firm size is an important determinant of access to credit. Access to credit is significantly more difficult for microenterprises than for small enterprises and considerably more difficult for small enterprises than for medium-size and large enterprises (figure 3.7). That pattern is consistent with a well-established fact across a variety of developing and even some developed economies. Consequently, microenterprises are more likely to report that access to finance is a serious obstacle. Even within the sample of formal firms, firms with fewer than 20 employees are twice as likely as firms with more than 20 employees to report
finance as a major or severe constraint. Although perception measures do not adequately capture the dimensions of a firm’s ability to borrow, we find similar size disparities in more objective measures of access to credit. Microenterprises are less likely to have a bank account. Only 41 percent of microenterprises have a bank account, compared with 90 percent of small and 99 percent of medium and large firms. That disparity is likely a major source of differences in access to credit. A bank account represents a banking institution’s primary channel of information about a potential borrower. These results are consistent with the recent financial access report for Kenya, which finds that informality and individual bank account holding are negatively related (www/fsdkenya.org/finaccess). The recent calls by the Central Bank governor for the establishment of a low-fee checking account resonates with some of the changes highlighted by the result above. Although loan application rates are similar between micro- and small formal firms, the proportion of small firms with a loan is double the proportion of microfirms that have a loan. The differences in access to an overdraft facility are even more glaring. Among microenterprises, only 3 percent have access to an overdraft facility compared with 66 percent among medium and large enterprises.

Figure 3.7  Access to Credit, by Firm Size

Source: ICA survey.
Note: Includes both manufacturing and nonmanufacturing enterprises.
The impact of firm size is evident even when we restrict the analysis to the formal sample. Within the SMLE subsample, small firms have less access than medium and large firms. For example, only 27 percent of small firms report having any credit products, compared with 55 percent of medium and large firms. This difference is statistically significant even after controlling for other factors that might affect access. Small firms are about 17 percentage points more likely to report that access to finance is a serious obstacle compared with large firms, ceteris paribus. In regard to objective measures, the gap widens between the smallest formal firms and large firms: small firms are about 46 percentage points less likely to have overdraft facilities and about 42 percentage points less likely to have a loan or overdraft than are large firms, holding all other factors constant. Relative to large firms, medium firms are only about 13 percentage points less likely to have an overdraft and 16 percentage points less likely to have a loan or overdraft. Small firms are also about 10 percentage points less likely to apply for a loan; however, after controlling for other factors that might affect the likelihood of submitting a loan application, this effect is no longer statistically significant.

Do differences in access also translate to differences in the price of debt or the term of the loans received by firms of different sizes? Table 3.1 shows the median price and duration for all formal firms in the sample. As the table shows, medium firms pay about 200 basis points more than do large firms. In regression analysis, after controlling for a variety of firm characteristics, we obtain a statistically significant size premium in the median price of debt. Small and medium firms pay about 100 basis points more than large firms, all other factors being equal; however, the size advantage does not translate to other aspects of the debt contract. Median loan durations are identical across all size categories, and collateral requirements are slightly lower for the smallest formal firms.

<table>
<thead>
<tr>
<th>Size categories</th>
<th>Annual interest rate</th>
<th>Loan duration months</th>
<th>Collateral requirements (percent loan value)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small (5–19 employees)</td>
<td>14.0</td>
<td>36.0</td>
<td>110.0</td>
</tr>
<tr>
<td>Medium (20–99 employees)</td>
<td>14.0</td>
<td>36.0</td>
<td>120.0</td>
</tr>
<tr>
<td>Large (100 + employees)</td>
<td>12.0</td>
<td>36.0</td>
<td>118.5</td>
</tr>
<tr>
<td>Total</td>
<td>13.9</td>
<td>36.0</td>
<td>120.0</td>
</tr>
</tbody>
</table>
Characteristics of Loan Products

Of the 657 firms in the formal sample, firms report 64 lines of credit and 208 loans. Most credit products observed relate to the manufacturing sector. There are only 12 lines of credit and 14 loans reported in the microenterprise sample of 124 firms. Almost all loans and credit lines to the formal sector (SMLEs) are issued by private commercial banks, with state-owned banks accounting for only an 8 percent share of all loans. Microfinance institutions dominate lending to microfirms, although private commercial banks account for 31 percent of loans to this sector (table 3.2).

About half the loans in our sample were obtained in 2006, with the earliest loan in 1974. The size of loans varies from 20 thousand to 20 billion Kenya shillings, with the median being 5 million (table 3.3). As a fraction of the estimated current value of the firm’s fixed assets the average loan-fixed assets ratio is about 36.5 percent (median 12.5 percent), which

Table 3.2  Credit Line/Loan Providers

<table>
<thead>
<tr>
<th>Type of financial institution</th>
<th>Microenterprises</th>
<th>SML enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No. of obs.</td>
<td>Percent</td>
</tr>
<tr>
<td>Private commercial banks</td>
<td>8</td>
<td>31</td>
</tr>
<tr>
<td>State-owned banks and/or government agency</td>
<td>5</td>
<td>19</td>
</tr>
<tr>
<td>Nonbank/microfinance institutions</td>
<td>12</td>
<td>46</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>Total</td>
<td>26</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: ICA surveys.
Note: SML enterprises include manufacturing and nonmanufacturing enterprises; obs. = observations.

Table 3.3  Loan Characteristics

<table>
<thead>
<tr>
<th>Variable</th>
<th>N</th>
<th>Min</th>
<th>Median</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year of approval</td>
<td>270</td>
<td>1974</td>
<td>2006</td>
<td>2007</td>
</tr>
<tr>
<td>Total duration in months</td>
<td>271</td>
<td>2</td>
<td>36</td>
<td>240</td>
</tr>
<tr>
<td>Amount at time of approval (Kenya shillings)</td>
<td>271</td>
<td>20,000</td>
<td>5 million</td>
<td>20 billion</td>
</tr>
<tr>
<td>Average annual interest rate (percent)</td>
<td>272</td>
<td>5.00</td>
<td>13.95</td>
<td>100.00</td>
</tr>
<tr>
<td>Collateral as a percentage of loan amount</td>
<td>245</td>
<td>20.00</td>
<td>120.00</td>
<td>400.00</td>
</tr>
</tbody>
</table>

Source: ICA surveys.
Note: Includes manufacturing and nonmanufacturing enterprises.
indicates a relatively moderate degree of leverage. The average and median nominal interest rates are about 13 percent. The average and median loan maturity is about three years.

**Loan Applications and Rejections**

Measures of loan application and rejection rates provide important information about impediments to accessing finance. We find that a relatively small proportion of firms applied for a loan in 2007. A total of 26 percent of microenterprises did so. Among formal SMLEs, 26 percent of small firms and more than one-third of medium and large firms applied for a loan in 2007. Rejection rates are surprisingly low for microenterprises: only 13 percent of loan applications were rejected. The corresponding rejection rate for small enterprises is 21 percent, and only 12 percent of large firms had loan applications rejected. The reasons for these rejections provide important insights into the types of policy interventions likely to improve access. Although the sample sizes used for this analysis are too small to be conclusive, it is worth exploring reported reasons. Inadequate collateral is the most frequently cited reason for rejection of loans among small formal firms. For medium and large firms, incompleteness of loan applications accounts for nearly half of all loan rejections (table 3.4).

Given the low rejection rates, it is surprising that application rates are not higher. One plausible explanation is that self-selection into applications produces a high-quality pool of loan applicants.

<table>
<thead>
<tr>
<th>Reason</th>
<th>SML enterprises</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Small</td>
<td>Medium-large</td>
</tr>
<tr>
<td>Collateral or cosigners unacceptable (%)</td>
<td>59</td>
<td>19</td>
</tr>
<tr>
<td>Insufficient profitability (%)</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Problems with credit history or report (%)</td>
<td>18</td>
<td>6</td>
</tr>
<tr>
<td>Incompleteness of loan application (%)</td>
<td>6</td>
<td>44</td>
</tr>
<tr>
<td>Concerns about level of debt already incurred (%)</td>
<td>0</td>
<td>19</td>
</tr>
<tr>
<td>Other objections (%)</td>
<td>11</td>
<td>6</td>
</tr>
<tr>
<td>Sample size</td>
<td>17</td>
<td>16</td>
</tr>
</tbody>
</table>

*Source:* ICA surveys.

*Note:* Includes manufacturing and nonmanufacturing enterprises.
Understanding why firms do not apply for loans is an important starting point for identifying the bottlenecks that are potentially rectifiable by policy interventions. We present the reasons reported by firms that did not apply for loans in table 3.5. Microenterprises are less likely to report “no need for loan” as a reason for nonapplication. Only 10 percent of microenterprises say they do not need loans, compared with 38 percent of small and 60 percent of medium and large firms. That corroborates the evidence presented previously that access to credit, particularly for micro- and small firms, is much worse compared with medium and large firms. Microenterprises are also more likely to be priced out of the market because of collateral requirements—43 percent of microfirms compared with 12 percent of small firms and 7 percent of medium and large firms report that collateral requirements discouraged loan applications. Given the preponderance of fixed assets as collateral and the size and scope of microfirms, it is not surprising that collateral requirements are an impediment to accessing finance for microfirms. Regression results confirm the importance of physical fixed assets in access to finance. Ownership of land is associated with a 19 percentage point increase in securing an overdraft or loan. In addition, firms that own land are nearly 13 percentage points less likely to have a loan application rejected. Together with collateral requirements, the application process itself is considered a major problem by both micro- and small firms, even though small firms complain more about

<table>
<thead>
<tr>
<th>Reason</th>
<th>Microenterprise</th>
<th>SML enterprise</th>
</tr>
</thead>
<tbody>
<tr>
<td>No need for loan (%)</td>
<td>10</td>
<td>38</td>
</tr>
<tr>
<td>Application procedures are</td>
<td>24</td>
<td>11</td>
</tr>
<tr>
<td>complicated (%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rates are not favorable (%)</td>
<td>13</td>
<td>26</td>
</tr>
<tr>
<td>Collateral requirements are</td>
<td>43</td>
<td>12</td>
</tr>
<tr>
<td>unattainable (%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Size of loan and maturity are</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>insufficient (%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Did not think it would be approved (%)</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Other (%)</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Sample size</td>
<td>92</td>
<td>231</td>
</tr>
</tbody>
</table>

Source: ICA surveys.
Note: Includes manufacturing and nonmanufacturing enterprises.
the interest rates. More specifically, a little more than one-quarter of small formal firms and one-sixth of medium and large firms fail to apply because of unfavorable interest rates. Less than 5 percent of firms across the entire size distribution report size of loan and maturity to be deterrents to accessing external finance. This suggests the absence of any rationing of credit. Finally, 11 percent of small formal firms find the application process complicated.

Notes

1. The question on perceptions asks whether the “access to and cost of financing” is a major or severe impediment to firm operation and growth. In the rest of the paper we use the phrase “access to finance” and “access to and cost of finance” interchangeably.

2. Differences in access to and the cost of finance are driven by a variety of factors, including economic growth prospects, the nature of bank ownership and regulation, and other demand- and supply-side factors that determine the quality of the marginal firm that has access to finance.

3. Microfirms are defined as firms with five or fewer employees.

4. These measures are derived from firm-reported data and as such do not address a variety of aspects of the market for external financing. For instance, our data allow us to observe whether a firm does not have a loan, an overdraft, or other debt instrument, but is uninformative as to why a firm is unable to secure financing. Although one possible interpretation is that there are problems on the supply side, it is quite likely that the firm has sufficient internal resources, did not present a sound financing proposition to external financiers, keeps bad records, or does not have sufficient collateral—all demand-side constraints that preclude a conclusion that banks are unwilling to lend. In an attempt to further elaborate on possible bottlenecks in the lending regime, later in this chapter we report the results of an inquiry into why firms do not use external financing options.

5. These are by no means the only or even the most important explanatory variables. We focus on these because the data to investigate their plausibility are available.

6. We need to keep in mind that low borrowing costs in China and India (and to a much lesser extent in Kenya) reflect structural features of the financial systems, particularly government ownership of major banks.

7. Manufacturing sector only.

8. It is possible that responses to this question refer to ex post durations rather than ex ante commitments by banks.

10. At 2006 exchange rates, that corresponds to a median loan size of about $70,000.
A well-functioning labor market is vital to the success of the government’s policies to establish a globally competitive economy and provide jobs to a growing population. This chapter uses the firm-level data provided by the personnel managers of surveyed firms together with individual-level employee survey data to describe the labor market in the manufacturing, retail, and services sectors. The chapter starts with a broad description of firm perceptions on a variety of labor market constraints and firm responses to these constraints, including training. The chapter then examines wage-setting behavior using firm- and worker-level data.

The data used for this chapter include 396 manufacturing, 150 retail, and 111 services sector establishments. Because of data availability, wage-setting behavior is examined only for manufacturing firms. The individual-level data come from 1,160 workers matched to the sampled firms in the manufacturing sector.

Labor market constraints are very low on firms’ lists of impediments to growth. Two constraints are pertinent to this chapter: the extent to which an inadequately educated workforce and labor regulations constrain the growth and operations of enterprises. An overwhelming majority of firms in Kenya do not perceive either to be a major or very severe impediment to growth. Less than 20 percent of all manufacturing firms report either
constraint to be a major or very severe impediment. The same holds true for the retail and services sector: less than 5 percent of retail firms and other services firms report being inhibited by either constraint. For firms in Kenya, labor regulations are much more important constraints than inadequate skills.

Worker Skills

Labor market constraints are at the bottom of firms’ lists of impediments to growth. In particular, the shortage of skilled workers is the least important constraint to the operation and growth of manufacturing firms in Kenya. About 8 percent of manufacturing firms report the shortage of skills as a major or severe impediment to growth. Figure 4.1 shows the proportion of manufacturing firms that report being constrained by a poorly educated workforce in Kenya and across a set of comparator countries. It is striking that the sample of firms surveyed in Kenya have the lowest proportion reporting major constraints, tied with Uganda. Twice the proportion of firms report inadequate skills in neighboring Tanzania. Predictably, middle-income countries register a higher proportion of firms unhappy with the quality of the workforce.

Figure 4.1  Percentage of Manufacturing Firms Reporting Skills Shortage as a Serious Constraint to Firm Operation—International Comparison

Source: ICA survey.

Note: Cross-country comparisons are only for manufacturing enterprises. In all countries shown the figure presents percentage of firms that report that skills shortage is a major or severe constraint to firm operation.
We include the unweighted proportion of manufacturing firms surveyed in 2003 as a guide to trends in firm perceptions of formal education during the past four years. The data show a very large downward trend in concerns about skills in Kenya. In particular, the proportion of firms concerned has dropped from 28 percent to a little more than 8 percent, a 70 percent decline in the proportion of firms concerned about formal worker training.1

Is it possible that the 2007 estimates conceal important variation across firm characteristics? We examine that possibility by looking at firm perceptions of formal worker training across sectors, firm size, export status, and ownership categories (table 4.1). Firms in the manufacturing sector are more than twice as likely as retail firms and more than six times as likely as service firms to report skills shortages as a constraint to performance. Medium-size, foreign-owned, and exporting firms in the manufacturing sector are more likely to report that lack of skills is a major or severe impediment than other firms are.

We advance three tentative explanations of why firms do not report any immediate concerns with the formal education of the workforce. First, it is possible that firms have made the necessary input-mix adjustments that are compatible with a low-skills workforce. Second, it is possible that the quality of formal training has risen sufficiently to match firm needs. This would suggest that firm-based training is an adequate substitute for poor formal education. Finally, it is possible that other binding constraints in the business environment dominate the importance of schooling. In other words, in an environment of low growth, driven by poor infrastructure services, we would not expect skills constraints to top firms’ lists of concerns.

We use data on the average education level of workers to examine the extent to which concerns about skills varies with skill intensity of operation.

### Table 4.1  Percent of Firms Reporting Skills Shortage as Major or Severe Constraint

<table>
<thead>
<tr>
<th>Firm category</th>
<th>Manufacturing</th>
<th>Retail</th>
<th>Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small (5–19 employees)</td>
<td>4.1</td>
<td>4.0</td>
<td>2.3</td>
</tr>
<tr>
<td>Medium (20–99 employees)</td>
<td>11.1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Large (100+ employees)</td>
<td>9.2</td>
<td>33.3</td>
<td>0</td>
</tr>
<tr>
<td>Nonexporter</td>
<td>6.8</td>
<td>3.3</td>
<td>1.80</td>
</tr>
<tr>
<td>Exporter</td>
<td>9.6</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Domestic</td>
<td>6.8</td>
<td>2.7</td>
<td>1.3</td>
</tr>
<tr>
<td>Foreign</td>
<td>13.2</td>
<td>10.0</td>
<td>10</td>
</tr>
<tr>
<td>Weighted average</td>
<td>8.9</td>
<td>3.5</td>
<td>1.4</td>
</tr>
</tbody>
</table>

*Source: ICA Survey.*
For the next two explanations, we can examine the extent to which training and employment growth affect perceptions of worker schooling.

Firms were asked to report the education level of the typical worker in the firm. We use these data to examine whether perceptions of skills shortages are related to average skill intensity of the firm. Table 4.2 shows the percentage of firms reporting major or severe constraints because of skills shortages. As average education levels increase, the proportion of firms with concerns about the availability of skills declines from 10 percent for low education firms to 6.5 percent for high education firms. These differences in perceptions, however, are not statistically significant, suggesting the availability of skills is not an important bottleneck.

By looking at training we explore the extent to which concerns about low levels of skills correspond to adequate responses by the firms. Table 4.3 shows the proportion of firms that report being constrained by inadequate worker schooling, by training and above-median growth.

Table 4.3 demonstrates that complaints about inadequately schooled workers are not associated with whether the firm provides training or whether the firm had an annual employment growth above 7.7 percent. This is consistent with the fact that inadequate worker education is low on firms’ list of constraints.

### Table 4.2  Do Reports of Skills Constraints Vary by Worker Education?

<table>
<thead>
<tr>
<th>Average education level</th>
<th>Percentage of firms reporting major or severe impedance as a result of skill shortages</th>
</tr>
</thead>
<tbody>
<tr>
<td>0–3 years</td>
<td>10.00</td>
</tr>
<tr>
<td>4–6 years</td>
<td>8.00</td>
</tr>
<tr>
<td>7–12 years</td>
<td>8.83</td>
</tr>
<tr>
<td>13 years +</td>
<td>6.49</td>
</tr>
</tbody>
</table>

*Note:* The estimates shown above are restricted to the manufacturing sector.

### Table 4.3  Share of Firms Reporting Skills as a Serious Constraint, by Training and Employment Growth

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does firm provide training?</td>
<td>9.87</td>
<td>7.38</td>
</tr>
<tr>
<td></td>
<td>(2.43)</td>
<td>(1.68)</td>
</tr>
<tr>
<td>Firm employment growth above median</td>
<td>9.41</td>
<td>7.22</td>
</tr>
<tr>
<td></td>
<td>(2.06)</td>
<td>(1.86)</td>
</tr>
</tbody>
</table>

*Note:* Standard errors in parentheses. The estimates shown above are restricted to the manufacturing sector. Median employment growth between 2003 and 2006 is 7.7 percent.
Another way of discriminating between some of the previous explanations is by examining the number of years of schooling of a typical worker in the typical firm in the manufacturing sector, from an international perspective.简单 comparisons of years of schooling completed could under- or overestimate differences in learning achievement given cross-country differences in the quality of a year of education. As Table 4.4 shows, the typical worker in Kenya has between 7 and 12 years of schooling. A total of 68 percent of firms report that their typical worker has between 7 and 12 years of schooling. Although that is lower than the corresponding estimates in middle-income South Africa, it is higher than in the other African comparators. A higher proportion of firms report typical education levels of more than 12 years: 17 percent of Kenyan firms report average education levels of more than 12 years of schooling—higher than in any comparators except Uganda.

An important avenue of human capital deepening is through firm-based training; however, the ability of firms to impart the requisite skills will depend on a variety of factors that include the extent of firm-level demand for skills development, the availability of external training by specialized firms, and financial and space constraints at the firm level. We examine the extent to which firms support skills development through on-the-job training. We abstract from implicit learning-by-doing (worker experience) and focus instead on formal on-the-job training programs.

In Kenya, about 41 percent of firms provide training to their workers. Of the firms that provide training, nearly two-thirds of skilled workers and about 50 percent of unskilled workers received training (figure 4.2).

To understand how training can be extended to more workers in Kenya, it is useful to identify the correlates and determinants of firm-based training. Figure 4.2 shows the proportion of firms with on-the-job training and the percentage of workers trained across a range of firm characteristics. There is a striking size training provision relation: large

<table>
<thead>
<tr>
<th></th>
<th>0–6 years</th>
<th>7–12 years</th>
<th>&gt;12 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uganda</td>
<td>36</td>
<td>45</td>
<td>18</td>
</tr>
<tr>
<td>Tanzania</td>
<td>35</td>
<td>57</td>
<td>8</td>
</tr>
<tr>
<td>Kenya</td>
<td>15</td>
<td>68</td>
<td>17</td>
</tr>
<tr>
<td>South Africa</td>
<td>10</td>
<td>78</td>
<td>12</td>
</tr>
</tbody>
</table>

Source: ICA surveys.
Note: Comparable data are unavailable for China and India.
firms are almost twice as likely to provide training as medium firms. The largest firms are three times as likely to provide training as small firms. The proportion of workers trained, skilled and unskilled, does not follow the same pattern: in fact, the pattern for skilled workers appears to be reversed, with the smallest firms training a higher proportion of skilled workers.

As with firm size, exporting firms and, to a much lesser extent, foreign-owned firms, are considerably more likely to provide training as are nonexporters and domestically owned firms, respectively. In addition, foreign-owned firms train a higher proportion of unskilled workers than do domestically owned firms. Not all relationships shown in figure 4.2 are robust, controlling for other associations. For instance, it is likely that the exporting and foreign ownership differences in training arise from firm-size differences in each of these two categories. To address that factor, we investigate the correlates of firm-provided training using regression analysis. We carry out a firm- and individual-level analysis.

After controlling for a variety of factors, only the firm-size characteristic is significant: a large firm is about 36 percentage points more likely to provide training than is a small firm. Likewise, a medium firm is about 19 percentage points more likely to provide training than a microfirm.

**Figure 4.2  Percentage of Firms Providing Training and Percentage of Workers Trained**

Source: ICA surveys.

Note: The figure shows percentage of firms that provide firm-based training and the percentage of skilled and unskilled workers that are trained. Only data for manufacturing firms are available.
We also find that firms that are active in human immunodeficiency virus (HIV) prevention or testing of their workers are 13 percentage points more likely to provide training than are other firms. Similar results have been observed with respect to training and HIV prevention in other countries in sub-Saharan Africa (Ramachandran and others 2005). This variable is assumed to measure the degree to which firms are sensitive to turnover of skilled workers and the skill intensity of production.

An examination of training at the individual worker level suggests that formal schooling is an important complement of firm- and individual-financed training. An extra year of formal schooling is associated with a 3 to 5 percentage point increase in the likelihood of receiving training (both firm- and self-financed). Further, we find evidence of a negative gender gap in firm-provided training: female workers are nearly 5 percentage points less likely to receive firm-based training. Union workers are more likely to receive firm-based training.

It is instructive to evaluate the extent of training provision from an international perspective. Manufacturing firms in Kenya lag behind the comparator countries with respect to on-the-job training (table 4.5). Slightly more than two of five firms provide training in Kenya, compared with more than 70 percent of firms in China and more than 60 percent in South Africa. Only India and Uganda have a slightly lower share of firms that provide training.

Conditional on providing training, firms in Kenya compare more favorably, falling in the middle of the distribution of all comparator countries with respect to the proportion of the workforce that is trained. The data used in this table, however, cannot determine the quality of the training provided.

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage firms offering training</th>
<th>Percentage production workers trained</th>
<th>Percentage nonproduction workers trained</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>16</td>
<td>7</td>
<td>6</td>
</tr>
<tr>
<td>Uganda</td>
<td>32</td>
<td>61</td>
<td>28</td>
</tr>
<tr>
<td>Kenya 2007</td>
<td>41</td>
<td>66</td>
<td>50</td>
</tr>
<tr>
<td>Tanzania</td>
<td>42</td>
<td>69</td>
<td>31</td>
</tr>
<tr>
<td>Kenya 2003</td>
<td>48</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>South Africa</td>
<td>64</td>
<td>45</td>
<td>47</td>
</tr>
<tr>
<td>China</td>
<td>72</td>
<td>48</td>
<td>25</td>
</tr>
</tbody>
</table>

*Source:* ICA surveys.
A comparison of the 2003 and 2007 samples suggests that the provision of firm-based training has not changed over time. In 2007 the percentage of firms that provided training was 45.6; in 2003 it was 44.2 percent. The difference is not statistically significant, suggesting that skills development does not appear to have changed much among formal, established firms.

**Labor Regulations**

Labor regulations govern the terms under which firms hire, utilize, and fire workers. These terms include remuneration guidelines, leave and overtime policies, and separation policies. We investigate the extent to which this regulatory regime is an impediment to firm operation in Kenya. Unlike concerns about the quality of the workforce, labor regulations are a moderate impediment to firm operation and growth. A total of 16.3 percent of firms in manufacturing find labor regulations to be a severe or major constraint to growth and operation (figure 4.3). The corresponding proportion in the retail and services sectors is less than 3 percent.

As figure 4.3 shows, labor regulations constitute a modest obstacle to the operation of firms in Kenya. In fact, this is in the bottom 5 constraints of the 17 bottlenecks presented. From an international perspective, Kenya

---

**Figure 4.3** Percentage of Manufacturing Firms Reporting Labor Regulations Are a Serious Problem—International Comparison

<table>
<thead>
<tr>
<th>Region</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uganda</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Tanzania</td>
<td>6.7</td>
<td>11.4</td>
</tr>
<tr>
<td>Thailand</td>
<td>14.3</td>
<td>14.5</td>
</tr>
<tr>
<td>India</td>
<td>14.3</td>
<td>14.5</td>
</tr>
<tr>
<td>Malaysia</td>
<td>16.3</td>
<td>16.3</td>
</tr>
<tr>
<td>Kenya 2007</td>
<td>20.7</td>
<td>22.5</td>
</tr>
<tr>
<td>South Africa</td>
<td>32.9</td>
<td></td>
</tr>
</tbody>
</table>

**Source:** ICA surveys.

**Note:** In all countries presented, the figure shows percentage of firms that report that labor regulation is a major or severe constraint to firm operation.
registers an intermediate proportion of firms that are constrained by labor regulations. Crucially, Kenya is behind both of its East African neighbors on this matter: only 7 percent of firms in Tanzania and 1 percent in Uganda complain about labor regulations. The graph shows that labor regulations are considerably more constraining in South Africa and Mauritius than in East Africa.

The trend in firms’ concerns about labor regulations has been moderately downward. Nearly 22 percent of the panel sample in 2003 found labor regulations to be a major or severe constraint, compared with 15.9 percent in 2007.

Firms were asked to report an elasticity of employment with respect to two aspects of labor regulations: hiring and firing workers. Firms were asked whether they would hire or fire more workers if the regulations governing both aspects were removed. In all, 2 percent of firms reported that labor regulations had affected hiring decisions, nearly 4 percent of firms report that regulations had affected their firing decisions, and 5 percent of firms had both firing and hiring constrained by labor regulations. In all, only 11 percent of firms report being constrained by labor regulations. The corresponding proportion of firms in the retail and services sectors is less than 2 percent. In general, the regulatory regime governing the hiring, remuneration, and firing of workers in Kenya appears reasonable to firms in all three sectors.

That finding is consistent with other evidence. The Doing Business report collects detailed information on how labor regulations affect hiring, firing, and rigidity of employment. On the basis of these regulations, the report calculates objective measures that assess how strict labor regulation is in the country. Kenya is ranked 68th of 165 countries surveyed in 2006. This ranking is considerably higher than that of all the middle-income comparators and much lower than Tanzania’s (figure 4.4).

**Wages**

Assuming uniform worker productivity across countries, the level of wages paid to workers would determine the competitiveness of the manufacturing sector in Kenya. The wage level and its growth trajectory is particularly important given that Kenya has been engaged in a 10-year strategy of attracting foreign direct investment. Given the advantages of a low regulatory burden and a relatively well-educated workforce (with respect to the region), it is important that wage levels remain competitive to support an attractive low-cost production environment. Rising wages
that are not commensurate with productivity gains are likely to result in the flight of foreign direct investment to more favorable destinations and greater competitive pressure from imports.

**Cross-Country Comparisons**

This section compares median wages paid to various worker categories with wages in comparator countries. These comparisons do not account for differences in human capital or the sectoral composition of manufacturing in the comparator countries. Figure 4.5 shows the median monthly wage in U.S. dollars paid to production workers.

The median monthly wage for a full-time permanent production worker in Kenya is $116. Wages in Kenya are generally higher than in other East African comparators. For example, median monthly compensation in Kenya is about 30 percent higher than in Tanzania and Uganda. Median production wages in Kenya are a small fraction of median pay in South Africa.

A comparison with the economies that dominate global manufacturing is telling. Kenyan wages are higher than wages in China and India. The typical Indian production worker earns about 60 percent of the Kenyan worker’s wage, and a corresponding Chinese worker earns about 80 percent of the Kenyan production worker’s median monthly earnings. Given that the aggregate numbers above conceal differences in sample composition, we restrict the analysis to the food and garment sectors for each of our
comparators. Figure 4.6 presents the results of such an analysis. Again, the ordering of median monthly wages is unchanged. Focusing on the garment sector, the median monthly wage paid in Kenya is nearly twice the wage paid in Tanzania. Median wages in Uganda, China, and India are about 70 percent of wages in Kenya.

In addition, we include a comparison between median wages (in 2005 US$) in the 2003 manufacturing sample. The previous estimates show that median wages in 2007 are virtually unchanged from the 2003 levels.

Comparisons across Firms in Kenya
Table 4.6 provides tentative evidence that very large firms pay median wages for production workers that are about 20 percent higher than the wages of small firms. Econometric analysis confirms that estimate. Although firm-level data show weak results, after controlling for individual worker characteristics results from worker-level regressions provide stronger evidence of this link: a worker earns more in a larger firm.

Foreign-owned firms pay about 20 percent more for nonproduction workers than do domestically owned firms. Exporters pay about 30 percent more for nonproduction workers compared with nonexporters. These differences in remuneration policy for nonproduction workers are
Apparent differences in pay for production workers by ownership and export status are not statistically significant. Firms with access to external credit do not appear to pay higher wages than firms without access to external credit, after controlling for other factors. Furthermore, we find that firms that use an external auditor do not pay more or less than nonexternally audited firms.

### Table 4.6 Median Monthly Wages by Occupation (2005 US$)

<table>
<thead>
<tr>
<th>Firm category</th>
<th>Production workers</th>
<th>Nonproduction workers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small (&lt;20)</td>
<td>93</td>
<td>150</td>
</tr>
<tr>
<td>Medium (20–99)</td>
<td>116</td>
<td>205</td>
</tr>
<tr>
<td>Large (100+)</td>
<td>116</td>
<td>231</td>
</tr>
<tr>
<td>Nonexporter</td>
<td>104</td>
<td>173</td>
</tr>
<tr>
<td>Exporter</td>
<td>116</td>
<td>231</td>
</tr>
<tr>
<td>Domestic</td>
<td>104</td>
<td>185</td>
</tr>
<tr>
<td>Foreign</td>
<td>116</td>
<td>220</td>
</tr>
<tr>
<td>Employment growth below median</td>
<td>116</td>
<td>231</td>
</tr>
<tr>
<td>Employment growth above median</td>
<td>110</td>
<td>173</td>
</tr>
<tr>
<td>Total</td>
<td>116</td>
<td>202</td>
</tr>
</tbody>
</table>

*Note:* All wages are converted to 2005 dollars using the exchange rate from the World Development Indicators.
Firms that provide training to workers pay higher wages to both production and nonproduction workers. This is consistent with human capital theory: the worker and the firm share gains in productivity resulting from training.

There is little evidence to support the idea that collective bargaining has a large impact on wage rates. Firms with higher unionization rates do not appear to pay higher wages to production workers than firms with lower rates, and union members do not appear to receive higher wages than other workers do, after controlling for other variables that might affect wages.

Unionization rates are not very high in Kenya. Among the comparator countries, only Tanzania, China, and the middle-income economies have higher unionization rates. A total of 31.3 percent of workers in Kenya’s manufacturing sector are members of a union. Unionization rates are even lower in the retail sector (7.4 percent) and the services sector (7.3 percent). Unionization rates are higher in larger firms. About 41 percent of workers in large manufacturing firms are unionized, compared with less than 17 percent in small firms.

Worker characteristics have a strong effect on wages. An extra year of schooling increases earnings by about 7 percent to 9 percent—on the high end of the distribution of returns to schooling found in developing countries. Returns to an extra year of schooling average only 4 percent in Uganda. High returns to worker experience are also documented. As was established previously, returns to an extra year in the labor market are positive at the beginning of a worker’s career and negative toward the end of the career. An additional year of experience increases wages by about 3 percent to 4 percent at the beginning of the career. There is no evidence of gender discrimination, holding constant worker attributes. Surprisingly, we find that workers who are union members earn nearly 25 percent less than nonunionized workers. The size of this effect declines as we include worker characteristics, suggesting worker-firm matching as a possible explanation for this finding. Workers who obtained their job through the network earn significantly less than workers hired through more formal channels. Finally, we find that firm size is a still significant factor in determining worker earnings.

**Absenteeism**

Workers miss an average of a half-day per month because of their own illness and a further half-day per month because of illness in the family. Figure 4.7 shows the comparison in worker absenteeism across Uganda,
Tanzania, and South Africa. The typical worker misses fewer days in Kenya compared with the rest of East Africa, but more than in South Africa. Using the estimates for South Africa as a reasonable standard, a firm in Kenya loses about eight days a year because of worker absenteeism. That is equivalent to just under 3 percent of working time in a calendar year.\(^4\)

One-fifth of firms asked in the survey reported that worker absenteeism had increased because of illness. Across sectors, there was minimal variation in the prevalence of illness-related worker absence, with 22 percent of firms in the manufacturing sector, 15 percent in retail, and 19 percent in the services sector. When asked specifically about HIV-related worker absence, an even smaller proportion of firms reported experiencing an uptick in worker absence. Overall, 5.5 percent of firms reported an increase in worker absence, with the manufacturing sector leading with nearly 7 percent of firms compared with 3.7 percent and 3.2 percent in the services and retail sectors, respectively.

**Notes**

1. Similar results are obtained if we use the panel portion of our sample.
2. Education data were not collected in the retail and services sectors.
3. For several reasons cross-country comparisons of wages using median wages for full-time permanent production workers can be different from comparisons using average labor costs from the firm’s financial statements. One notable difference between the two measures is that labor costs from the firm’s financial statements include wages for nonproduction workers, managers, and professionals. Many other factors can also affect results, including the ratio of production to nonproduction workers, ratios of skilled to unskilled production workers, differences in average (relative to median) education levels, differences in ratios of full-time and part-time workers, and differences in ratios of permanent and temporary workers.

4. This assumes a working calendar of just under 250 days.
The Kenya ICA survey included a separate survey of microenterprises, those with fewer than five employees. It is estimated that more than 80 percent of manufacturing employment in Kenya is generated by firms in that sector. Understanding the characteristics of the sector, its impediments to growth, and its reasons for choosing to remain informal is essential for the government to design appropriate policies that will encourage firms to become formal, stimulate industrial growth, and reduce the current dualism in the industrial sector.

**Registration Characteristics**

A total of 124 microfirms were surveyed in Kenya. Of these 52 percent were located in Nairobi, and 16 percent around each of the other cities: Mombasa, Nakuru, and Kisumu. Most firms surveyed were in the manufacturing sector (74.2 percent); others were in the construction, retail, and service sectors. Most firms (75 percent) were sole proprietorships; others were partnerships.

On the basis of the information collected, the microenterprises surveyed can be subdivided into those that have any formal registration and those that do not. Firms are classified as “registered” if they have done at least one of the following:
• Registered name with the Office of the Registrar or other government institutions responsible for approving company names
• Registered with the Office of the Registrar, the local courts, or other government institutions responsible for commercial registration
• Obtained an operating or trade license or otherwise registered for a general business license with any municipal agency
• Obtained a tax identification number from the tax administration or other agency responsible for tax registration

In our microenterprise survey, we see that of the 124 firms surveyed in this group, 58 percent have a municipal license, less than 40 percent have a commercial license, only 28 percent have their company name registered, and only 27 percent are registered for tax purposes. Those that are registered for tax purposes have most other registrations also. In all subsequent analysis, these are defined as “formal” microenterprises. Firms select themselves to register and formalize operations: we examine the characteristics of this group versus those that choose informality (e.g., not registered for tax purposes), to identify key factors that govern those choices. As discussed in the microenterprise literature, firms may choose to formalize to gain greater access to the formal financial system and to avail themselves of public infrastructure facilities and other government services. They do so also to avoid the burden of tax evasion and noncompliance. However, firms that choose to remain informal are likely to do so when the costs of being formal and adhering to all the regulatory and tax laws are greater than the benefits provided by formality. They may also remain informal if they simply do not have the knowledge required to formalize.

**Benefits of Formality: Access to Finance and Land**

Firms were asked to rank various areas of the investment climate to determine which constraints present the largest obstacles to enterprise operations. These rankings are presented in figure 5.1, disaggregated by formal versus informal status.

From figure 5.1, we see that more than 80 percent of informal microenterprises rank access to finance to be a major constraint, compared with 55 percent of formal micros. Similarly, access to land is ranked as a major constraint by 33 percent of informal firms against less than 15 percent of formal micros. Do these differences in rankings reflect differential access to the formal financial sector by registered firms?
Microenterprises, both formal and informal, rely significantly more on internal funds and retained earnings to finance their working capital and investment than do firms in the formal sector. On average, microfirms finance about 78 percent of working capital and 85 percent of new investment with retained earnings, compared with 61 percent and 68 percent for formal businesses. Unsurprisingly, bank financing accounts for only 3.8 percent and 5.1 percent of microfirms’ working capital and new investment needs compared with 10.9 percent and 23.3 percent for establishments in the formal sector (Figure 5.2). This is likely explained by the fact that trade credit-producing relationships are long-lasting relationships and microfirms are generally very young or face a high probability of closure, which potentially discourages the provision of supplier credit.

As figure 5.3 demonstrates, good account keeping is essential for obtaining access to the banking sector, particularly for borrowing. Approximately 40 percent of formal microfirms report audited accounts, compared with a negligible number of informal micros. Most formal micros have access to deposit accounts, whereas less than 30 percent of informal micros have that access. The distinction is even greater for borrowing—more than 40 percent of formal micros have loans or a line of credit, compared with only about 10 percent of informal microfirms. This suggests a potentially large and positive effect of formalization on access to credit. On the one hand, microfirms that engage in some formal activities might generate better information on which banks can lend. Alternatively, semiformality likely signals a measure of unobserved firm quality or the desire to formalize. Informal
Figure 5.2  Percentage of Firms Using Various Sources to Finance New Investment and Obtain Working Capital, by Firm Size

Source: ICA surveys.
firms, on the other hand, prefer not to engage in any level of formality and consequently are not bankable.

We examine this issue by estimating the probability of having a deposit account and the probability of having a current loan. After controlling for a number of factors such as entrepreneur education, previous experience, land ownership, and registration status, we see that university-educated entrepreneurs are more likely than others to have bank accounts and loans, ceteris paribus. Registration status matters, after controlling for entrepreneur skills. Formal firms are much more likely to have a bank account and loans, indicating either some requirement within the banking sector or some self-selection out of the banking sector by informal firms.

Access to land is also ranked as a bigger problem by informal firms, compared with formal microenterprises. Most microfirms, both informal and formal, do not own land. Only 13 percent of microfirms do, compared with 40 percent of enterprises in the formal sector. Contrary to what we would expect, however, four times as many informal firms (36 percent) own land than do formal firms (9 percent). Nevertheless, they do not have access to the banking system. Hence, the issue of registration is more important than being able to provide collateral. In addition, as shown in the finance chapter, the major constraint to access to finance for microfirms is the complexity of the application procedure.

**Costs of Formality: Taxes, Burden of Inspections, and Business Licensing**

When examining the ranking of constraints across firm types, we see that besides problems pertaining to electricity and transport (which affect
firms in both the formal and informal manufacturing sectors and are discussed in detail in the business climate chapter), formally registered microfirms find the burden of tax administration and regulatory requirements to be a major constraint.

One of the main benefits of informality is the ability to avoid taxation. The survey data confirm that presumption. In Kenya, informal firms declare only 20 percent of their sales, compared with more than 80 percent declared by formal microfirms. What is unique is that the spread is highest in Kenya, indicating that this tax obstacle could drive the choice of informality (figure 5.4). That explains why informal firms do not report the tax burden as the top reason for not choosing formality. For them, the main reason is the minimum capital requirement and the costs of registration.

However, apart from obvious areas such as tax administration,1 there is no significant difference between formal and informal microfirms with regard to the reasons for choosing informality. Although the data show some variations across firms, the financial burden of registration and taxation plus the minimum capital requirements are the main reasons that firms do not choose formality (figure 5.5). Not surprisingly, regression analysis shows that only the administrative burden of complying with all tax laws appears as a significantly more important burden for formal microfirms than for informal microfirms.

Microfirms are more easily subjected to harassment by tax officials. Although microfirms are visited as frequently as formal firms—close to 80 percent of microfirms report having been visited by tax officials last year—the difference between visits to formal and informal micros is striking. Firms that have chosen informality are visited once every three

**Figure 5.4 Percentage of Income Reported for Tax Purposes: Microenterprises**

![Graph showing percentage of income reported for tax purposes in various countries]

*Source: ICA survey.*
to four days by tax officials, compared with formal microfirms, which are visited once every three to four months (figure 5.6). That is much higher than in any comparator country. In many instances, microfirms report corresponding expectations of bribes—36 percent of those that report inspector visits say that a bribe was expected at the time of the visit. Again, there is a big difference between formal and informal firms. Formal

**Figure 5.5  Perceived Reasons for Choosing Informality**

<table>
<thead>
<tr>
<th>Reason</th>
<th>Formal</th>
<th>Informal</th>
</tr>
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<tbody>
<tr>
<td>strict labor marker rules</td>
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<tr>
<td>adm. burdens (e.g., inspections)</td>
<td></td>
<td></td>
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<tr>
<td>adm. burden of complying with tax laws</td>
<td></td>
<td></td>
</tr>
<tr>
<td>financial burden of taxes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>minimum capital requirements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>cost of registration procedures</td>
<td></td>
<td></td>
</tr>
<tr>
<td>time to complete registration</td>
<td></td>
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<tr>
<td>difficulty of getting information</td>
<td></td>
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</table>

Source: ICA survey.

**Figure 5.6  Median Number of Visits/Required Meetings with Tax Officials per Year**

Source: ICA survey.
microfirms reported being asked for bribes 15 percent of the time, whereas informal firms reported being asked almost three times as often (44 percent). More generally, informal firms are more subject to bribes. They pay 1 percent of sales more in illegal payments to get things done compared with formal microfirms.

Notes

1. Since informal firms do not deal with tax administration they would naturally not rate it as a problem.
2. The mean values are even higher for Kenya: 141 visits for informal firms, 33 for formal firms. Firm interviewers reported that typically informal microfirms were visited by inspectors to obtain free access to firm services, such as a free meal.
CHAPTER 6

Recommendations

This report identifies the main constraints to private sector development in Kenya on the basis of a survey conducted in 2007 of approximately 650 formal firms in four locations in the country. Perception and objective indicators confirm that tax rates, finance, and corruption remain the three most important impediments. Electricity and transport are identified by Kenyan managers as the main infrastructure constraints; security and licensing are reported as constraints as well. To address these bottlenecks, we propose the following recommendations.
1. Taxes
High taxes are the most reported bottleneck in Kenya. Objective indicators of fiscal pressure suggest that the tax burden in Kenya remains higher than in most comparator countries. If all taxes and fees are considered, Kenyan firms are still required to pay half their corporate income in taxes, an overall amount that is much higher than in the other African comparator countries.

• Kenya has recently reduced the tax rates corporations face. The most important reforms in corporate income taxes have focused mainly on lowering rates in efforts to combat global competition. Rates have been reduced from a peak of 45 percent in 1990 to about 30 percent today.

2. Finance
Although we observed a decline in the proportion of firms constrained by access to finance since 2003—from 75 percent to 36 percent—access to credit is significantly more difficult for smaller firms. A total of 90 percent of microenterprises and 60 percent of small firms declare they need loans, compared with 40 percent of medium and large firms. Hence, firm size is an important determinant of access to credit. Among microenterprises, only 3 percent have access to an overdraft facility compared with 66 percent among medium and large enterprises. Similarly, only 27 percent of small firms report having any credit products, compared with 55 percent of medium and large firms. Together with

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<th>Policy Matrix</th>
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<tr>
<td><strong>Problem</strong></td>
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<tr>
<td>1. Taxes</td>
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<tr>
<td>2. Finance</td>
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</tbody>
</table>
collateral requirements, the application process itself is also considered a major problem by both micro- and small firms.

- Promotion of new products is being undertaken by the private sector—as in the revolution in m-banking created by Safaricom’s M-Pesa and Equity Bank’s vast increase in client outreach. New product development has also been supported by the UK Department for International Development/World Bank Financial Deepening Trust in areas such as weather insurance, warehouse receipts, and payments system innovation.

- Capacity building is being supported by the Bank’s Micro, Small, and Medium Enterprise (MSME) project, which promotes lending to small and medium enterprises (SMEs) and business development services.

- Computerize the property registration process, and simplify taxes and fees. Efficient land registries and the ability to easily perfect and transfer land titles are important vehicles to provide property owners with access to collateralized financing. Backlog and paper-based records necessitate that all history of transactions relevant to the property be checked every time.

- Promote the application of innovative products and technology to expand access to finance. Capacity building for banks and microfinance institutions in the use of different lending technologies, secured lending, leasing, mortgage finance and, in the longer run, the promotion of new products such as warehouse receipts or weather insurance is likely to have a large impact on financial depths.

- To promote improved access by small businesses to the products and services of commercial banks, facilitate the provision of capacity building for small businesses to better understand the requirements of banks (how to approach banks for business loans and how to use bank services) and prepare them for a relationship with a commercial bank.

(continued)
3. Corruption
Although the ranking of corruption has improved during the past four years, Kenyan firms still place it among the most important constraints to their business. Nearly 70 percent of firms that reported corruption as a binding constraint ranked it as a top constraint. Corruption takes many different forms, from making payments for utility hookups to informal payments in public procurement. In general, three-fourths of firms in Kenya reported having to make informal

- The government of Kenya (GoK) now posts on the ministries’ Web sites all information on contracts, including names of contractors, decisions of the Procurement Appeals Board, bidders and tender outcomes, and contractors’ performance. Contracts above 5 million shillings are posted on the Web site hosted at Treasury. Plans are at an advanced stage for local hosting at Public Procurement Oversight Authority
- Conduct an in-depth study of corruption in the country
- Give prosecutorial power to the Anti-Corruption Authority, and publicize better the successful anticorruption cases
- Tax administration: continue reforms aimed at – Minimizing human contact between taxpayer and officials and making the process more transparent by relying heavily on information technology to file tax returns
payments to “get things done” with rules and regulations. This costs Kenyan firms approximately 4 percent of annual sales. The Enterprise Survey data allow us to identify the many aspects of a business that create opportunity for illegal payments. For instance, Kenyan firms are required to pay approximately 12 percent of the value of a public contract as informal payments. One-third of surveyed firms reported being subjects of informal payment requests from tax inspectors visiting them. That is high by international standards. Licensing represents yet another opportunity for informal payments to be made. When dealing with licenses, Kenyan firms are requested to make informal payments approximately one-fourth of the time. Furthermore, one particular aspect of corruption that seems to be unique to Kenya is the common practice of the police requesting payments from trucks in transit. Finally, the share of managers concerned about the functioning of the courts—of those that actually used them—rises to 33 percent, on a par with crime and tax administration.

- GoK is proposing to blacklist companies found to have been involved in cases of corruption in accordance with the new procurement law. No requests for blacklisting have been received so far from any of the procuring entities.
- GoK is taking steps to accelerate implementation of a more coordinated and prioritized e-government initiative, with public access to procurement as one of the highest near-term priorities.
- GoK is taking steps to establish mobile visiting courts in sparsely populated areas. Visiting courts at Mpekotoni, Archers Post, Wamba, Loitokitok, Dadaab, Kakuma, and Marimanti have been upgraded to full-fledged courts.
- GoK is taking steps to incorporate alternative dispute resolution mechanisms and provision of legal aid schemes. The Rules Committee is considering experiences learned during a study tour, with a view toward creating a pilot project in the Milimani Commercial Court.
- GoK is taking steps to launch comprehensive wireless-based public information hubs in

- Establishing independent internal and external audits
- Introducing organizational changes of the Revenue Authority: incentives for high performers, sanctions for corrupt behavior, career development, and competitive salaries
- Public procurement: continue reforms aimed at
  - Reviewing procurement rules with the goal of simplifying tender documents, reducing the minimum value of a contract for single source, and introducing anticorruption laws, performance standards, and sanctions
  - Improving transparency in public-private interactions through e-procurement, publication of tender documents and tenders received, and public participation in negotiations
  - Introducing a vetting system (conducted by international firm, possibly with involvement of civil society) to prequalify companies interested in bidding for government contracts to address conflict of interests and fraudulent companies

(continued)
districts and constituencies, with public access to government a high priority.

- Restructuring and privatization of Telkon Kenya is ongoing.

- Establishing an independent tender evaluation and auditing and monitoring unit rates
- Supporting a greater level of integrity and professionalism among multinationals and domestic companies through professional associations, codes of conduct, monitoring and benchmarking, and integrity pacts

- Police
  - Have observers join the trucks to monitor requests for bribes. Use recording systems to monitor traveling time and illegal behavior.
  - Establish computerized checkpoints to make the process more transparent and quicker with the least possible interaction between truck drivers and police officials. Educating truck drivers about the automated system will also reduce the harassment they face.
  - Install an electronic weighing station.
  - Involve associations engaged in trucking operations in sensitizing truck drivers to comply with the rules and regulations.
  - Establish an independent police complaints commission entrusted with following up on the implementation of the reform program.
  - Reduce the discretionary power of police.

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<tr>
<th>Problem</th>
<th>Action Taken</th>
<th>Recommendations</th>
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*Policy Matrix*
4. Electricity
Close to 80 percent of firms in Kenya experience losses because of power interruptions. This is the highest percentage of all comparator countries. Consequently, almost 70 percent of firms have generators, which are costly to obtain and operate. Power disruption costs Kenyan firms approximately 7 percent of sales. In a cross-country comparison, these losses are among the highest.

- Since June 2006, KPLC has been managed by an international management services contractor.
- KPLC made a profit in FY2005/06 and FY2006/07. During FY2007/08, KPLC’s performance has continued to improve—for example, network losses were reduced. As of mid-2008, the government was providing a nontargeted subsidy to electricity consumers of K Sh 0.60 per kilowatt-hour.
- The conversion of the Electricity Regulatory Board to the Energy Regulatory Commission on July 7, 2007, was an important step in the

- Increase public investment in energy generation, transmission, and distribution to increase connectivity.
- Encourage increased private financing and investment in the energy sector—today, the private sector accounts for 12 percent of the power supply.
- Establish clear rules for private generators’ “open access” to the transmission network, the concept of which was established in the Energy Policy.
- Ensure that electricity pricing maintains the financial viability of power companies, while protecting the most vulnerable consumers.

(continued)
right direction. By taking that action, the government has moved the power sector one step closer to being overseen by an independent regulatory entity with the clear legal authority for performing the universal tasks of such an entity: setting tariffs and the quality of service standards and licensing operators.

- The establishment of the Rural Electrification Authority in 2007 has transferred responsibility for rural electrification from KPLC to the Rural Electrification Authority. The authority will manage the Rural Electrification Fund, with an expected annual turnover of K Sh 4 billion (US$60 million) of government funds plus any donor funds made available to it.

5. Transport
Managers identified transportation, together with electricity, as the two leading infrastructure constraints to doing business in Kenya. The strong discontent of Kenyan firms is echoed by the high direct and indirect costs they have to bear because of the quality of the transportation infrastructure. Even worse, shipping a 40-foot container costs Kenyan firms much more than firms in all other

<table>
<thead>
<tr>
<th>Problem</th>
<th>Action Taken</th>
<th>Recommendations</th>
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<tr>
<td>right direction. By taking that action, the government has moved the power sector one step closer to being overseen by an independent regulatory entity with the clear legal authority for performing the universal tasks of such an entity: setting tariffs and the quality of service standards and licensing operators.</td>
<td>• Develop the legal framework for investments in energy. • Consider using the least-cost development plan to increase investments in energy</td>
<td></td>
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</table>

- The establishment of the Rural Electrification Authority in 2007 has transferred responsibility for rural electrification from KPLC to the Rural Electrification Authority. The authority will manage the Rural Electrification Fund, with an expected annual turnover of K Sh 4 billion (US$60 million) of government funds plus any donor funds made available to it.

- The Ministry of Finance should establish a system for ensuring proper investment planning and management. This would, among other things, involve
- Issuing guidelines for a minimum level of preparation of projects before they are submitted for budget requests, including compatibility with the overall sector strategy and development plan, economic analysis,
comparator countries, except Uganda. Unfortunately, when we look at indirect costs Kenya does not perform any better. Kenyan companies lose 2.6 percent of their sales to spoilage and theft during transportation. That is the highest percentage of all comparator countries.

investment plan, but that now awaits governmental adoption.
• To efficiently manage the entire road network in Kenya, the government passed the Kenya Roads Act and has established three roads authorities, namely, the Kenya National Highways Authority, Kenya Rural Roads Authority, and the Kenya Urban Roads Authority.
• The chair and members of the board of the three authorities have been appointed, and the authorities will become operational as soon as the three CEOs and senior staff are appointed. The government has also adopted a detailed road sector policy and strategy paper that will form the basis for future programs and reforms in the sector.
• The Ministry of Roads has drafted a policy paper on the involvement of the private sector in the management of truck weigh stations and axle load control.
Aviation
• The Kenya Airports Authority and the Kenya Civil Aviation Authority have been given financial autonomy and now retain the revenue generated from their operations, confirmation of having prepared detailed designs based on field investigations and the required bidding documents, and readiness for implementation
• Strengthening the institutional structure for implementing the guidelines. A special unit could be set up to screen projects submitted for budget funds. Such a unit would have a close working relationship with the Medium-Term Expenditure Framework and Bank Supervision Department units in the Ministry of Finance and would be the repository of a multiyear rolling investment program containing an inventory of appraised and priority-ranked projects for budgetary consideration in the future.
• Ongoing reforms in the roads sector should be expedited. That would involve
  – Expediting the operationalization of the Kenya National Highways Authority, the Rural Roads Authority, and the Urban Roads Authority
  – Strengthening the residual Ministry of Roads to perform its overall policy, planning, and coordination role
  – Promoting the use of long-term output and performance-based contracting or

(continued)
which had been previously remitted to the Treasury.

- The responsibility for passenger, baggage, and mail security screening at the airports has been transferred from the police to the Kenya Airports Authority, allowing for better monitoring, control, and training of security staff.
- The regulations for safety and security have been harmonized and adopted by all four member countries of the East African Community.

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<th>Problem</th>
<th>Action Taken</th>
<th>Recommendations</th>
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<tbody>
<tr>
<td>concessioning for maintenance and management of the major road network by the private sector, starting with the Northern Corridor</td>
<td>• The government should improve governance in the road sector:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>– Strengthen the Engineers’ Registration Board, and empower it further to discipline and sanction engineers and firms who perform poorly and violate its charter with regard to professional conduct and ethics.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>– Assist the construction industry in establishing a professional body for construction contractors (national construction council or a contractors’ registration board), and strengthen it to engage in self-regulation.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>– Develop a comprehensive construction industry development policy, and establish a dedicated construction industry development board to implement the policy to enhance the performance of the construction industry.</td>
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</tbody>
</table>
– Ensure regular updating of contractors’ qualifications and capacity, facilitate training in different aspects of construction and supervision techniques, and reprimand poor performance.
– Approve policy on private sector participation in the management of weigh stations and control of axle load regulations.

• Improve the public transportation system.
• Facilitate more private involvement in transport.

Port and Maritime
• Expedite conversion of Kenya Ports Authority to a landlord authority.
• Concession the Mombasa container terminal(s), the dockyard and marine services, and the bulk oil terminals.
• Streamline cargo clearance procedures, and remove the police escort system for transit cargo by road (except for hazardous and military supplies).
• Introduce risk-based targeting for cargo inspection and verification.
• Implement a harmonized customs clearance system and one-stop border posts in accordance with COMESA protocols.

(continued)
### Policy Matrix

<table>
<thead>
<tr>
<th>Problem</th>
<th>Action Taken</th>
<th>Recommendations</th>
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<tbody>
<tr>
<td>Review and ensure compatibility of local maritime regulations with the International Maritime Organization treaties.</td>
<td>• Review and ensure compatibility of local maritime regulations with the International Maritime Organization treaties.</td>
<td></td>
</tr>
<tr>
<td>Aviation</td>
<td>• Expedite safety and security enhancement at Jomo Kenyatta International Airport, and strengthen the Kenya Civil Aviation Authority to obtain International Air Safety Association and United States Transportation Security Administration Category 1 clearance to operate direct flights to and from the United States.</td>
<td></td>
</tr>
<tr>
<td>Railways</td>
<td>• Expedite putting in place the independent multisector regulatory body, in particular, for the railway sector.</td>
<td>• Convert the residual Kenya Railways Corporation into an asset holding company that would also monitor and evaluate the performance of the concession.</td>
</tr>
</tbody>
</table>
6. Licensing and Regulatory Governance

Approximately 20 percent of managers interviewed placed licenses among the top three constraints, and more firms complain about them than in all other comparator countries. Reforms notwithstanding, Kenya does not perform as well as comparator countries in areas such as new business starts, license renewals, and license costs.

• Since 2005, the World Bank Group, with support from development partners, have provided technical assistance to the government of Kenya (the Business Regulatory Reform Unit at Treasury and other agencies) on licensing and regulatory reforms.

• The Kenyan government has recognized the importance of the licensing burden, and a number of reforms directed at reducing the number of licenses were approved in 2006 and 2007. The reform program has, for the first time, identified 1,325 active business licenses, eliminated 315 of them, simplified 379, and cut the time and cost of obtaining building permits. Notably, 23 of a priority list of 26 problematic licenses identified by businesses have been eliminated or simplified. The still-ongoing program will eventually eliminate or simplify at least 900 more of the country’s 1,300 licenses.

• In the next stages, the regulatory reform and capacity-building project will assist the government of Kenya in preparing and implementing a regulatory reform strategy. The projects will continue to support

• Follow up with the implementation of the licensing reforms.

• Reduce the overall burden of licenses imposed on businesses, including a reduction in time and costs of obtaining a license to undertake business operations.

• Continue establishment of an electronic register of licenses.

• Adopt a regulatory reform strategy to serve as a framework for licensing and other regulatory reforms and to ensure their sustainability.

• Reduce the burden imposed on businesses by on-site inspections.

• Tackle licensing and regulatory reforms at the local government level.

• Introduce a system for vetting proposed regulations to ensure that they do not place an undue burden on businesses.

• Reduce the cost of trade documents.

• Reduce minimum capital requirement to register a company.

• Reduce the costs to start a business.

• Reduce the time taken to start a business.

• Reduce time for processing a VAT refund.

• Reduce the number of payments for social security contributions and for VAT payments.

(continued)
licensing reforms (including setting up an electronic registry of all valid licenses), streamlining inspection procedures, introducing a system for vetting new licenses, addressing regulatory reforms at the local government level, and building the capacity of stakeholders to ensure the sustainability of the licensing reforms.

- Establish online filing, as is already done in South Africa and Mauritius.
- Harmonize the different tax identification numbers (PIN, VAT, etc.) into one universal number.
- Identify clear responsibilities to continue licensing reforms.
- Improve information and transparency on regulatory reforms and outcomes.
- Reduce time for VAT refunds by allowing firms to use it as credit toward next payment.
- Reduce number of licenses by local authority, and clarify the legal status of the “circular.”

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<tr>
<th>Problem</th>
<th>Action Taken</th>
<th>Recommendations</th>
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<tr>
<td>Licensing reforms (including setting up an electronic registry of all...</td>
<td>• Establish online filing, as is already done in South Africa and Mauritius.</td>
<td>• Harmonize the different tax identification numbers (PIN, VAT, etc.) into one...</td>
</tr>
<tr>
<td></td>
<td>• Streamline inspection procedures.</td>
<td>• Improve information and transparency on regulatory reforms and outcomes.</td>
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<tr>
<td></td>
<td>• Introduce a system for vetting new licenses.</td>
<td>• Reduce time for VAT refunds by allowing firms to use it as credit toward next...</td>
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<tr>
<td></td>
<td>• Address regulatory reforms at the local government level.</td>
<td>• Reduce number of licenses by local authority, and clarify the legal status of...</td>
</tr>
<tr>
<td></td>
<td>• Build the capacity of stakeholders to ensure the sustainability of the licensing reforms.</td>
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Technical Appendix

Enterprise Survey in Kenya: Sample Design

The World Bank’s 2007 Enterprise Survey in Kenya was administered to 781 firms in four locations. Appendix Table 1 shows the sample distribution across cities and sectors. The sampling approach used was stratified simple random sampling for the formal economy and simple random sampling for the microfirms. Close to 60 percent of the formal sample is represented by manufacturing firms, within which food and beverages (17 percent), garments (12 percent), and other manufacturing (31 percent) represent individual strata. Outside the manufacturing sector, the retail sector accounts for 19 percent of the sample, and fewer than one-quarter of the firms belong to the rest of the services stratum.

In regard to geographical distribution, the capital city has the highest number of firms (60 percent) in the sample; the rest is distributed across the other three locations, Mombasa, Nakuru, and Kisumu. Finally, 124 microfirms (with four employees or fewer) are also included in the sample. They are about equally split between Nairobi and the rest of the country.¹
<table>
<thead>
<tr>
<th>Sector</th>
<th>Nairobi</th>
<th>Mombasa</th>
<th>Nakuru</th>
<th>Kisumu</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>274</td>
<td>51</td>
<td>34</td>
<td>37</td>
<td>396</td>
</tr>
<tr>
<td>Food and beverages</td>
<td>73</td>
<td>13</td>
<td>8</td>
<td>16</td>
<td>110</td>
</tr>
<tr>
<td>Garments</td>
<td>62</td>
<td>13</td>
<td>2</td>
<td>5</td>
<td>82</td>
</tr>
<tr>
<td>Other manufacturing</td>
<td>139</td>
<td>25</td>
<td>24</td>
<td>16</td>
<td>204</td>
</tr>
<tr>
<td>Retail</td>
<td>59</td>
<td>16</td>
<td>26</td>
<td>25</td>
<td>126</td>
</tr>
<tr>
<td>Rest of the services</td>
<td>69</td>
<td>20</td>
<td>22</td>
<td>24</td>
<td>135</td>
</tr>
<tr>
<td>Total—formal</td>
<td>402</td>
<td>87</td>
<td>82</td>
<td>86</td>
<td>657</td>
</tr>
<tr>
<td>Micro (4 employees or fewer)</td>
<td>64</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>124</td>
</tr>
<tr>
<td>Total</td>
<td>466</td>
<td>107</td>
<td>102</td>
<td>106</td>
<td>781</td>
</tr>
</tbody>
</table>

*Source:* ICA Survey.

**Note**

1. Note that the sample was not stratified by size. The appendix in the full ICA report includes a detailed description of the sampling methodology followed.
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Although the circumstances in which Kenyan firms must do business have improved since 2004, including an increase in productivity, Kenyan firms still face an adverse business environment. An Assessment of the Investment Climate in Kenya reports on the main impediments to productivity growth identified by managers of Kenyan businesses:

- **Lack of access to financing.** Despite a favorable lending regime, 90 percent of microenterprises and 60 percent of small firms in Kenya declared that they needed loans, compared to 40 percent of medium-sized and large firms.

- **Corruption and crime.** Seventy-five percent of firms in Kenya reported having to make informal payments to “get things done.” This sort of corruption costs Kenyan firms approximately 4 percent of annual sales. In 2007, approximately one-third of Kenyan managers rated crime as a major business constraint. In addition, Kenyan companies lose 2.6 percent of their sales because of spoilage and theft during transportation.

- **Unreliable infrastructure services.** Transportation and energy remain significant bottlenecks. Close to 80 percent of firms in Kenya experience losses because of power interruptions. As a consequence, almost 70 percent of firms have generators, which are costly to obtain and operate.

Managers also complained about taxes. Kenya has reduced corporate tax rates in recent years, but some objective indicators suggest that the country’s tax burden remains higher than in most comparator countries. Given the potential impacts of high taxes—high evasion and the presence of a large informal economic sector—the report recommends a more detailed assessment of the effective rate of taxation.

An Assessment of the Investment Climate in Kenya recommends specific changes in each of these areas of constraint, as well as in the areas of transportation and regulatory reform. The book will be of interest to readers working in business and finance, economic policy, corporate governance, and poverty reduction.