Case study commissioned by the Department for International Development, UK

A Contribution to WDR 2005 on Investment Climate, Growth and Poverty

Improving the Business Trade Licensing Reform Environment

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November 2003

Key Messages

1. This Kenyan case study shows that red-tape costs can be cut if reform is championed strongly and there is a strong case in terms of costs and benefits.
2. The reform of trade licensing is a cost effective and progressive way to promote indigenous private sector development.
3. Reform needs more than good cost-benefit analysis and legal drafting; it requires building constituencies and continuous advocacy.

The views and opinions expressed in this study are those of the author and do not necessarily correspond to the views or policies of the Department for International Development (DFID), UK.

The author wishes to acknowledge contributions to this case study and the project work upon which it is based from: Graham Bannock, Clive Davis, Hugh Scott (DFID), David Turnbull and the staff and directors of KIPPRA

Introduction

1. As in most developing countries, the indigenous private sector in Kenya is dominated by Micro and Small-Scale enterprises, (MSEs). The 1999 Baseline Survey of MSEs carried out by the Central Bureau of Statistics (CBS) shows that the sector is a significant employer and generates an estimated 13.8% of the country's Gross Domestic Product (GDP).[1] The survey showed that there are 1.3 Million Micro and Small-Scale enterprises, employing approximately, 2.3 million workers.

2. As Davis and Okech have commented, this contribution to GDP may be underestimated.[2] The total available workforce is estimated at 13.5 million. Urban unemployment is estimated at 35 percent. The number at work therefore is 8.8 million before rural under-employment and unemployment is taken into account. The number engaged in the MSE sector thus represents 26% of the workforce. However, according to the CBS Baseline Survey it accounts for only 13.8% of GDP. It has been suggested that the proportion of GDP accounted for by this sector is as much as 40%.

3. The Kenyan Government has been aware of the significance of the business environment for some time. During the first half of the 1990s it undertook a series of reforms to facilitate import- and export-based operations. These reforms included:

(i) 1991 removal of import and export licensing requirements,

(ii) 1992-1994 (phased) removal of exchange controls,

(iii) 1993 removal of price controls, and

(iv) 1995 introduction of the convertible Kenyan shilling.

4. These reforms helped the small number of larger firms involved in import-export, but the overall policy environment remained very unsympathetic to business. Recognising this, in 1996 the UK Department for International Development (DfID), in conjunction with the Government of Kenya, in 1996 initiated the Kenya Deregulation Project (KDP), based in the Ministry of Planning and National Development.

KDP: quantifying the cost of regulation, and savings from deregulation

5. KDP helped to establish a Deregulation Section in the Ministry, which began its work by carrying out a survey of entrepreneurs' costs for complying with various types of government regulations. This survey identified three cost areas which far outweighed all others, namely, costs involved in obtaining:

i) titles to land or property,
ii) access to finance from banks or other formal sources, and
iii) licenses required for business operation (known as "trade licenses").

6. While it has made some limited progress in the first two areas, KDP's most significant achievement is its transformation of Kenya's trade licensing system. Why was it in this area? First, KDP was able to make a persuasive, quantitative case for reform which neutralised the major political opposition to reform. Second, the politics in this instance was less high profile than either land or finance/credit politics, which enabled objective, economic arguments to carry the day.

7. KDP commissioned a local research institution, the Nairobi-based Institute for Development Studies, to calculate the costs of specific regulatory regimes for firms.[3] Bannock Consulting and KDP staff (what about DFID staff/advisers?) then considered what savings might be possible if adjustments could be made to two of the key laws underlying the regimes, the Registration of Business Names Act, and the Trade Licensing Act. Interviews with firms unearthed some startling news, most notably firms' reports that they received an average of 8.5 visits/year from officials resulting in "public relations payments" to avoid matters arising under the poorly understood registration procedures. Both central and local government authorities had developed cumbersome, expensive procedures around the two laws, leaving businesses coping with inspections by two different sets of officials.

8. This produced the following analysis:

Estimated Annual Savings of Deregulation

(All costs in Kenyan Shillings)

	Total estimated cost to firm	Estimated Annual Savings
Registration of Business Names Act		
Compliance		
Official	1,083m	108m
Unofficial	896m	90m
Travel	164m	16m
Time	1,272m	127m
Total	**3,415m**	**341m**
Non-compliance		
Public relations payments	2320m	1,856m
Evictions, arrests, etc.	356m	427m
Time	171m	182m
Total	**2847m**	**2,466m**
Trade Licensing Act		
Compliance		
Official	946m	0m
Unofficial	830m	415m
Travel	59m	29m
Time	585m	293m
Total	**2,420m**	**737m**
Non-compliance		
Public relations payments	324m	259m
Evictions, arrests, etc.	211m	169m
Time	419m	336m
Total	**954m**	**764m**
Grand Total	**9,636m**	**4,308m**

Source: Bannock 1998, adjusted from raw data of REME/IDS 1998.

9. The potential annual saving of KSh 4,300 million represented 1 percent of GDP at the time. This caused the Government of Kenya, particularly the Ministers for Local Government and Finance, to take notice. The Minister for Local Government issued a Circular in January 1999 demanding that local officials introduce a simple, Single Business Permit (SBP) replacing the opaque multiple trade licensing system. The SBP was introduced on a mandatory basis from 1 January 2000. In the related Finance Act

2000, which established a key formal mechanism for distributing a share of income tax to local governments, local authorities' entitlements for such funds were tied to performance in implementation of SBP.[4]

10. During 1999 some 30 (out of 174) local authorities introduced the SBP system. By August 2001 only 13 local authorities had not fully completed implementation, thanks to strong support from a parallel, World Bank-financed Kenya Local Government Reform Programme, which embraced local licensing reform as a key task. Today the SBP is used by almost all local authorities.

11. In 2000 an evaluation by Bowles and Odhiambo[5] compared micro/small, medium and large firms' costs in 3 districts that had implemented SBP with 3 that still maintained multiple trade licensing procedures. They multiplied these average savings by to 21 the populations of the different sizes of firms, obtained from the 1999 baseline survey of Kenyan firms. They concluded that total savings with SBP implemented in all districts would be around 0.08 percent of GDP.[6] This is approximately KSh 451 million/year, or almost £4 million/year, which for a single year constitutes benefits several times the total DFID funding for all business regulation reform in Kenya since 1996.

Central Trade Licensing Reform: Unfulfilled promise

12. KDP's quantitative analyses, in addition to demonstrating the potential of local licensing reform, showed the burden to the economy of maintaining a complex system of central trade licenses. As seen in the table above, the analyses show considerable costs in time and effort to travel to Nairobi to obtain and renew (annually) these licenses. The smaller the firm, and the farther its base from the capital, the more onerous this regime has been. To make matters worse, KDP's investigations revealed that the Government was spending approximately a shilling on administering this system for every shilling it was receiving in fees. Reform of central trade licensing offered potential savings far greater than those achieved with the SBP.

13. The Ministry of Finance was persuaded by the analysis and the 2000 Budget speech committed the Government to eliminate central government trade licensing, except for a small number of activity sectors which represent special concerns for public health and national security (arms manufacture, for example). This led to a Cabinet memorandum to amend thirteen specific Acts to implement this reform.

14. Unfortunately, to this day Cabinet has not acted on this memorandum. Two factors have hindered progress. First, and probably most important, there has been no strong Kenyan private sector voice pushing for this reform. The matter was raised through sound research and analysis carried out within government, with minimal private sector involvement (only serving as survey respondents). The Kenyan private sector, until recently, has been fragmented, politicized and pursuing narrow interests.[7]

15. Secondly, the KDP itself has not operated from a stable nor particularly well suited institutional base to pursue the "implementation" side of the policy agenda. This initiative first was housed in the Ministry of Planning and National Development, moving briefly to the Ministry of Labour and Social Policy, before transfer to its present home in the quasi-autonomous Kenya Institute for Public Policy Research and Analysis (KIPPRA). While all these institutional homes support quality research and analysis, neither government Ministry was prepared to advocate strongly for reforms, and KIPPRA has not seen this sort of direct lobbying as part of its mandate.[8] The messy work of building a constituent base behind the 2000 Budget Report recommendation, completing the detailed drafting of the specific amendments necessary, and shepherding the proposal through Cabinet, and then through Parliamentary review, has lacked an enthusiastic champion. The potential for reform remains, and the new political climate may lead to the emergence of the needed champion; but for the present, central trade licensing remains in its over-regulated form.

Conclusions

Quantifying the costs and benefits of regulation essential for identifying priority problems and making a strong case for reform.

16. Every regulation has vested interests. Most regulations have some "public good" intention behind them. Quantifying costs and benefits at firm level clarify where good intentions are outweighed by unintended consequences. There was substantial opposition to licensing reform in Kenya, mostly from bureaucrats responsible for trade and industry matters (at central and at local level). KDP demonstrated the significant cost to the economy of excessively complex licensing procedures, and the revenue neutral nature of fee collection. While there were still groups seeking to protect their authority to issue multiple licenses (often with additional rent-seeking in mind), the majority in Cabinet and in Parliament were persuaded by the objective arguments of KDP.

Reforming registration, licensing and other business entry procedures is a cost effective and progressive way to promote indigenous private sector development.

17. Kenya's change to a Single Business Permit is estimated to save businesses £3.8 million per year. At its peak expenditure level, the Kenya Deregulation Project was spending in the order of £400,000 per year. Few other means of promoting private sector development show this return on investment. Moreover, as smaller firms are the hardest hit by excessive and inappropriate regulation (costs as percentage of annual turnover), Kenya's smallest firms will be the largest beneficiaries from this reform.

Enabling environment reform needs more than good cost-benefit analysis and legal drafting. Implementing policy change needs hands-dirty work, in building and sustaining constituencies for reform, and managing the day-to-day chores of advocacy. It needs strong champions in the public and the private sector.

18. While Kenya has made significant progress in implementing the Single Business Permit, much potential reform still remains on the table. This has not been due to any shortage of quality analysis and proposals. Instead, it has been due to the absence of strong champions for reform in the public and the private sector. The future of reform in Kenya will depend on establishing an institutional champion for better regulation at a high level in government, and on nurturing the development of the Kenya Private Sector Alliance as a unified private sector voice for regulatory reform.

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Notes

[1] CBS GEMINI Baseline Survey, 1999.

[2] Davis and Oketch, 2002.

[3] REME/IDS 1998.

[4] Davis and Oketch 2002.

[5] Bowles, Odhiambo and Aboutha, 2000 This survey, taking place at an early stage of implementation of these reforms, provides a very conservative estimate of their benefits.

[6] Bannock Consulting, MLHRD/DFID Deregulation Project Phase II, Seconde External Review, August 2000, pp.12-14.

[7] See Darroll and Scott, June 2003. The advent of the Kenya Private Sector Alliance, a by product of the major trade associations' coordinated efforts to influence the PRSP plan in 2001, and the opportunity presented by the recent political transition, may herald an important change in this situation.

[8] The latest DFID review of its work in Kenya, now titled "Umbrella Project: Improving the Enabling Environment for Private Sector Development", recommends contracting out implementation of reforms to another party, recognizing that KIPPRA, a first rate policy research and advisory body, does not have a comparative advantage in the nitty gritty work of lobbying. See Darrol and Scott, 2003.