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The Second Decade: A Basic Economic Report on Kenya

Annex 3
Key Issues in the Private Sector
(Vol. IV of Five Volumes)

January 15, 1974

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Eastern Africa Regional Office

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UNITS OF VALUATION

The official unit of currency in Kenya is the Kenya Shilling (Sh.) However, in accordance with the practice of the Kenya Government, most large values in the report are expressed in Kenya Pounds (£)

£ 1 = Sh. 20
Sh 1 = 100 cents

Some values have been expressed in terms of constant US dollars for purposes of international comparison.

CURRENCY EQUIVALENTS

From Independence at the end of 1963 until March, 1973, the exchange rate between the Kenya Shilling and the US dollar was retained at \$1 = Sh.7.143. This is the exchange rate used throughout the report. Since June 30, 1973, the Kenya Shilling, together with those of Tanzania and Uganda, has been set at a central rate of \$1 = Sh.6.9, and all three countries have availed themselves of the wide margins of up to 2¼ per cent.

		<u>Exchange Rate</u> <u>Used in the Report</u>	<u>Present Rate of Exchange</u>
US dollar	=	Sh. 7.143	Sh. 6.9
Kenya Pound	=	\$ 2.80	\$2.8985

THE MISSION

This report is based on the findings of an IBRD mission which visited Kenya in March/April, 1973. The main mission consisted of the following Bank staff:

John Burrows	-	Chief of Mission
Ramgopal Agarwala	-	Macro-Economist
George Beier	-	General Economist (Project Planning and External Assistance)
Ved Gandhi	-	Fiscal Economist
Randolph Harris	-	General Economist (Public Services)
Martin Wolf	-	General Economist (Private Sector)

Sven Burmester (Education), Andrew Hayman (Tourism) and Frank Stubenitsky (Health) also participated in the work of the Mission and have contributed to the report. Lyle Hansen was adviser to the Mission.

A preliminary report was prepared in August and discussed with the Government of Kenya during October 1973. The present report incorporates the comments of Government, and where possible, includes more recent material.

PREFACE

1. During the course of 1972, the World Bank decided to embark upon a series of "basic" economic reports on its major member countries. The nature of country economic work has been under review for some time in the Bank, and the decision to undertake these major reviews on a regular basis reflects the general desire to improve both the quality and the usefulness of this work. The basic economic report is intended to provide a periodic overview of the operations of an economy. From the Bank's point of view, these reports are intended to provide a new perspective of the longer term structural developments in an economy, to assess the extent to which they can be shaped by policy changes, and to identify the country's external assistance requirements. But more than this, a basic economic report is expected to provide a synoptic view of the many facets of the economy, and thus to bring into focus other work being undertaken by the Bank and elsewhere at a sectoral or project level. From the country's point of view, it is hoped that these policy-oriented reports will be valuable in giving objective and possibly new insights into the dynamics of the economy and the options which may be open to the Government in the future management of the economy.

2. This is the first basic economic report on Kenya. The timing is particularly appropriate as Kenya prepares to enter the second decade of Independence and is about to publish the Third National Development Plan. We feel that it is therefore a suitable time to assess how far Kenya has come during the past ten years, to review her major successes and failures, to assess what prospects lie ahead, and to identify major policy issues. This is the main purpose of the report. Of course, this is not the first Bank report to undertake this task, but the latest in a series. For example, the Bank published a report on the Kenya economy in 1963 which reviewed the development prospects of the country as it moved towards Independence. In 1967, a major Bank mission reviewed the revised development plan (1966-70) and again in 1969 another mission reviewed the second (1970-74) plan. Each of these missions and the subsequent reports differed in composition and scope, but all served to make a critical review of Kenya's national plans and to offer constructive comments. At the request of the Government, both the 1969 mission and the recent 1973 mission visited Kenya while the new plan was still in draft form, so that the comments of the mission could be taken into account before the plans were published.

3. A report of this nature must essentially be the result of a compromise between comprehensiveness and brevity. The Kenya economy is much too broad and its operations much too complex to allow for complete coverage, even in a "basic" report. We have therefore deliberately circumscribed the scope of the report in a number of ways which it is important to make clear at the outset. First of all, the report is intended to be a review of the operations of the Kenya economy only, and makes no attempt to review progress or prospects of the wider region to which the Kenyan economy belongs, or even to assess in any comprehensive way how Kenya's development prospects are affected by her membership of the East African Community. Some of these relationships are referred to when they are of particular relevance, but the report has not tried to view the Kenyan economy from an integrated regional perspective. This limitation does not in any sense mean that either the Mission or the Bank feels that regional economic considerations are unimportant. On the contrary, it is clear from its major financial commitment to the EAC

corporations and the development bank that the Bank fully supports this unique development in regional cooperation which Kenya, Tanzania and Uganda have pioneered. The report focuses on Kenya and ignores the wider Community simply to keep the scope of the report within manageable bounds. This narrow focus becomes seriously myopic only in those sections of the report (on trade policies for instance) where Kenya must clearly act in concert with her partners in the Community. Again, while we try to suggest what options might be best for Kenya, viewed in isolation, we are very conscious that these options will have to be reviewed by all three Partner States, and that the decisions will ultimately be taken with the interests of the whole region in mind.

4. The scope of the mission was circumscribed in a second major respect. Even in its focus on Kenya, the report will not undertake a detailed review of all sectors of the economy and of all economic problems. The economic literature on Kenya is prolific, and we have drawn heavily on this. In particular, the recent ILO/UNDP Report on Employment, Incomes and Equality in Kenya has presented a very comprehensive and innovative analysis of unemployment and poverty, and we make no attempt to go over this ground again. Rather, we see this report, with its broader macro-economic focus, as being essentially complementary to the ILO/UNDP Report. We have not attempted to add in any significant way to the existing knowledge on the various sectors; instead, we have tried to consolidate and integrate this knowledge into our overall understanding of the operation of the economy. Similarly, we have not placed great emphasis on reviewing progress under the Second Plan or on describing the objectives of the Third Plan, because these tasks have been done very well by the Government itself.

5. Our report does not therefore try to deal with everything in great depth. On the contrary, it draws heavily from the wide range of studies already available and tries to use this information to provide a synoptic view of the way in which the economy as a whole functions and perhaps some new insights into important relationships between variables. Thus, while the report tries to be as informative as possible and to present sufficient background data on most aspects of the economy for the general reader, the detailed analysis is highly selective and focuses mainly on a number of key issues which we see as critical to the future development of Kenya and the well-being of its people.

6. The report is divided into five volumes. The main report traces the major developments in Kenya's first decade of independence, identifies the emerging issues, and examines the major options open to the Government in the future, as the Mission sees them. The remaining four volumes contain the analytical annexes, which discuss the major issues in detail and extend the technical arguments.

7. An outline of the complete report is shown on the opposite page, and a select bibliography of some of the major sources of information on Kenya is given at the end of Volume I.

THE SECOND DECADE
A BASIC ECONOMIC REPORT ON KENYA

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ANNEX 3 KEY ISSUES IN THE PRIVATE SECTOR

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(1) Erratum: Table 15 -- delete note 5.

CHAPTER 1. INTRODUCTION

The Scope of the Annex

1.01 The major purposes of the annex are to examine the key structural features of the private sector and the policy environment in which it operates, to explain performance, and to consider the range of alternatives which appear to be open to the Government in influencing the future role of the private sector. Our main focus will be on the urban formal sector, ^{1/} not only because of its prime importance within the private sector, but also because we believe that its performance has a profound effect on almost everything else in the economy.

1.02 In examining the performance of the urban formal sector, we shall be particularly concerned to study the overall environment in which it operates. There are three crucial areas of the environment which will be reviewed. The first, which covers trade policy, wage policy and access to credit, concerns the responsiveness of the private sector to prices. The second area of concern is the effect on the private sector of the increasing range of controls which Government has imposed on trade, factor use and financial transfers. The third section will focus on the role of foreign private investment and, in particular, on what it has given and might give to the Kenyan economy.

Limitations of Focus

1.03 It is clear from the above that the annex is not intended to be a full sector review, in the normal sense of the term as used in the Bank, and that the discussion will not therefore range over all the conceivable issues. For example, some important factors affecting the development of the private sector, such as the provision of infrastructure and services, will not be reviewed at all. It is also clear that some of the issues dealt with, while crucial to the efficient operation of the private sector, may not be amenable to Government influence or control. However, for the most part, the emphasis will be on policy and the policy choices which appear to be emerging in Kenya.

^{1/} We define the "urban formal sector" in the same way as the ILO/UNDP employment mission. (See "Employment, Incomes and Equality - a Strategy for Increasing Productive Employment in Kenya," International Labour Office, 1972). The sector approximately equals non-agricultural activity in the "modern sector" as that term is used in official publications of the Government of Kenya. We shall use the term "modern sector," as interchangeable with "formal sector", whenever comparisons with official statistics are thereby facilitated. In Appendix 3, we suggest, however, that the distinction between the formal and informal sectors is, at least in some respects, artificial.

1.04 Two particularly conspicuous gaps in the coverage of the annex need to be explained. The first is that, by concentrating on the activities of the urban formal sector, the annex gives little direct attention to the informal sector. This has been done deliberately, because we feel we can add little to the analysis of the informal sector and the recommendations for its development contained in recent publications. 1/ In particular, the recent ILO/UNDP report, as the definitive work on the subject, needs no supplementation. We are in broad sympathy with the view that the urban informal sector is economically productive and of particular value in providing opportunities for employment. It is also clear that much can be done - as indicated in both the reports referred to - to remove the impediments now operating on small businessmen and to assist their development. 2/ Such a change in policy would make a substantial contribution to the creation of labor intensive activities, the development of indigenous entrepreneurship, the use of local materials and the provision of cheap goods and services to the poor. We endorse these recommendations. However, we do not believe that the development of the informal sector can be the basis of an entire development strategy for Kenya and, as indicated above, this annex will focus on the direct and indirect effects of the formal sector, which we feel will continue to be dominant in the economy. In this way, we feel the annex will be complementary to the ILO/UNDP report and its innovative analysis of informal activity.

1.05 The informal sector is important to the following discussion in three ways. The first, and most important, is that policies directed toward formal activities (and most policies are) have very important indirect effects upon the rest of the economy, not least on the informal sector. Wage policy in the formal sector, for instance, has ramifications throughout the entire economy. These external effects will be a major theme of the annex. Second, the informal sector is important in a technical sense in the analysis of the reservation price of labor and its effect on migration and wage levels. Finally, the informal sector will appear in the concluding discussion of basic trade-offs between targets.

1.06 Thus, this paper will not deal with the informal sector's requirements as a sector in its own right, nor will it make any further attempt to quantify its role in the economy; nor will it attempt to add to the little that is now known about the demand and supply linkages of formal and informal urban activity. However, all the important effects of the formal sector on the informal and of the choices between the two, so far as they exist and are known, will be considered.

1.07 An even more conspicuous gap in our discussion will be the exclusion of agriculture from major consideration, even though agriculture is the most important part of the private sector and has been singled out in the

1/ "Economic Progress and Prospects in Kenya", Vol. II, Annex A "Small-Scale African Business," IBRD Report No. AE-22, March 3, 1972; ILO/UNDP op. cit. See especially Introduction, Summary and Recommendations, pp. 21-22, Chapter 13, and Technical Paper No. 22.

2/ Appendix 3 to this annex discusses the legal and other reforms required to assist this development, and in Annex 5 we suggest a program for the development of small scale business.

basic analysis of the report as the key sector in Kenya's future development strategy. A major review of the agricultural sector itself, the prospects for development, and the key issues and constraints facing it has recently been undertaken by the Bank, 1/ and therefore need not be repeated here. In this annex, we are concerned only to show that the urban formal sector has important indirect effects on agriculture, especially through trade policy, which taxes it, through its dominant influence on wage policy, and through the pre-emption of credit. As with the informal sector, questions of indirect effect, of relationship, and of options are considered, but the agricultural sector is not treated to any material extent as a separate entity.

The Basic Theses

1.08 There are three basic theses underlying the discussion in this annex. The first is the fundamental hypothesis that the urban formal sector is not only a leading sector in the economy but that its existence and operation has a profoundly important effect on all the other sectors of the economy - particularly agriculture and the informal sector. Given this thesis, it follows that we are concerned both with the direct effects of policy on the performance of the sector itself (which are important and not always understood) and with the indirect effects which these policies have on the rest of the economy.

1.09 The second basic thesis is that the urban formal sector has not performed as effectively as it might and that, under present policies, it is even debatable whether formal sector activity is beneficial to the economy. The substantive argument here is that there are certain major distortions which have arisen from existing policy, and that these distortions have induced the private sector to develop in a less-than-optimum way. It follows from the first thesis that these policy distortions will also have an important effect on the rest of the economy, and it is contended that an insight into these interactions is crucial to an understanding of the economy and of the policy options open.

1.10 The last basic thesis is that there may be certain conflicts between basic objectives, some of which may only now be starting to emerge clearly. For example, some important goals - such as accelerated Kenyanization or the need to limit the extent of foreign participation - may conflict with the goal of maximum growth, while the successful development of the sector itself may have considerable side effects on the economy as a whole and particularly on the informal sector. Some of these conflicts between ends, it should be noted, would still exist even if the distortions in policy were removed, although many would disappear.

The Method of Approach

1.11 In considering the options open to Government in managing the private sector, we shall be concerned about means, not ends. Thus, much of the

1/ See Agricultural Sector Survey Kenya, IBRD Report No. 254-KE, December, 1973.

discussion will center around alternative methods of achieving given goals. For example, we shall not suggest whether foreign investment is desirable or not, since this is ultimately a political choice, but will suggest how foreign investment could be made to contribute more to the Kenyan economy. In several places, therefore, we may suggest that there might be better ways (that is, less costly ways) of achieving a given aim. On the other hand, as pointed out above, we shall demonstrate that the basic goals of society may sometimes conflict with each other and that such conflicts will have to be resolved before a sound policy package can be formulated.

1.12 The discussion will center around the issues referred to above, namely the effect of price signals and controls on the private sector, and the policy towards foreign investment. Under each of these issues, the logical sequence of analysis will be first to look at the policy situation and assess its effects on performance, and then to examine the policy options which appear to be open, given the basic objectives and the major constraints.

1.13 In the concluding section, we shall attempt to bring into focus the implications of these major issues for overall strategy. The emphasis in this final section will be on the basic kinds of choices which appear to face the Government. The most important are those between incentives and controls and the cost and benefits of unconstrained formal sector growth.

CHAPTER 2. THE ROLE AND PERFORMANCE OF THE PRIVATE SECTOR

The Role of the Private Sector

2.01 Since independence, Kenya has looked to the private sector to provide the major impetus to development. The importance attached to private enterprise by the Kenya Government has been stressed in a series of official publications and statements 1/ and has been borne out by the policies applied since Independence. In its reliance on private enterprise, Kenya's development policy differs significantly from that of most other black African countries, which have tended to put more emphasis on the role of the public sector in spearheading development. It is true that Kenya has made it very clear that private investment - and particularly foreign investment - is only welcome if it can be seen to benefit the economy and has never advocated a complete laissez-faire doctrine. 2/ In recent years, Government has also decided to increase its participation in the enterprise sector in order to achieve effective Kenyan control over key sectors of the economy. Yet it is apparent that the Kenya Government is still committed to a mixed economy in which the private sector will continue to play a dominant role.

2.02 In applying this philosophy, the Kenya Government has followed a pragmatic policy of encouraging both local and foreign entrepreneurship by providing a generally attractive environment and a broad range of direct and indirect assistance. Domestically, the social and political atmosphere has been favorable to the development of entrepreneurial ability and initiative, and the Government has been anxious to foster the growth of indigenous enterprise by regulating the activities of non-citizens (as in the Kenyanization of trade) and by taking direct measures to assist the African entrepreneur in overcoming the initial problem of establishment. For the foreign firm, the natural economic attractions of investment in Kenya have been enhanced by the political stability of the country, liberal taxation and free repatriation of profits and a ready availability of protective devices. As we argue later in this annex, these measures, while financially attractive to the individual entrepreneurs, have not necessarily been to the economic benefit of the country as a whole.

1/ The basic development philosophy, first enunciated in the original KANU Manifesto before Independence, was incorporated in Sessional Paper No. 10, 1965 "African Socialism and its Application to Planning and Kenya" and has formed the basis of successive national development plans.

2/ "The Government expects the private sector to play a large role in development, subject, however, to firm guidance and explicit controls when necessary." Para. 120 "African Socialism and its Application to Planning in Kenya," op. cit. This statement has been prophetic of the role of Government in controlling private sector development. The nature of the firm guidance and explicit controls will become apparent in later chapters.

2.03 In overall terms, the private sector has indeed borne the major burden of development, even though the relative role of the public sector has grown rather more important over the years. Since 1964, in fact, the private sector has contributed over 60 percent of the real growth in value added, and still accounted for 70 percent of GDP at factor cost in 1972. At a more disaggregated level, private activity is particularly important in the two largest productive sectors, namely agriculture and manufacturing. In 1972 agriculture accounted for about one third of GDP, and virtually all of this was in the private sector. In the same year, manufacturing accounted for 11.5 percent of GDP, of which 82 percent was private. In fact, private activity accounted for over half of value added in all enterprise activities except for electricity and water and transport, storage and communications, where the proportion of private activity was much smaller. 1/

2.04 More striking than the high proportions of private activity is the relative constancy of these proportions. There are two major economic sectors where the public sector has expanded at the expense of the private. These are the electricity and water sector, which is now almost completely under public ownership, and banking, insurance, and real estate, in which the private sector share has dwindled from 72 percent to 51 percent since Independence. In all other sectors the role of private activity has either remained roughly constant or grown, as in forestry or building and construction.

2.05 The private sector is also the major source of employment in the Kenyan economy. In the modern sector, the private sector accounts for about 61 percent of wage employment or a little less than its share of GDP (See Table 1), but estimates of employment should include the self-employed and those employed outside the modern sector, if the true contribution is to be assessed. Such estimates are notoriously unreliable, but from calculations shown elsewhere in the report, a figure of five million for the total labor force in Kenya is not unreasonable, of whom 95 percent work in some form of private activity. 2/

2.06 It is clear, therefore, that Kenya has relied on private activity as the major development force in stimulating productive activity and in providing employment opportunities to the expanding population. This policy has changed little since 1964. Because of this emphasis, a close look at the policy environment is clearly desirable. For, although the strategy has paid off in terms of the development record, certain problems have arisen and will be discussed in the following sectors of the annex.

1/ See Table 4.

2/ See Annex I, Table 4.

Past Performance of the Private Sector

2.07 This is not a sector review but an analysis of policy. For this reason, the detailed performance of the various sectors will not be discussed. The overall performance of the economy is described elsewhere in the report, and at this point, it is only necessary to pick out those particular aspects of the performance of the private sector which are relevant to the present discussion. Subsequently, some detailed points will be made in discussion of each policy and its effects.

2.08 Assessment of performance can be done in two ways, namely, by looking at levels achieved or by looking at relationships between variables. The first approach would consider levels of output, employment or investment against some target, perhaps plan expectations. The second approach would concentrate on asking whether, given the investment, output growth is satisfactory or, whether given the output growth, employment growth was reasonable. This second approach is adopted here for two reasons: the first is that a line of logic going from targets, to realization, to policy defects and requirements, is appropriate to the review of a plan, which this paper is not; the second is that the approach taken here is to consider how to get as much as possible out of an activity by analysis of its environment. Crucial defects in the environment will appear in the relationships between variables rather than from a statistic in isolation.

2.09 As is shown in Table 2, the compound real rate of growth of private sector gross value added was 5.6 percent between 1964 and 1972. ^{1/} Within the monetary sector the fastest growing activity was a rather small one, namely building and construction, which grew at 12.3 percent per annum. Of the two major sectors, the fastest growing was manufacturing, which achieved an overall compound rate of growth of 7.6 percent per annum, compared with agriculture's 6.3 percent per annum. As a result, manufacturing's share of private monetary value added grew from 18 percent in 1964 to 20 percent in 1972, while agriculture remained at 32 percent. The striking feature of these figures is that, while indicating change, they do not reveal any rapid transformation of the economy. It is important to note that one of the economy's most important activities, namely tourism, does not appear in these national accounts. However, the growth of several sectors is related to tourism, especially other services. Direct value added in tourism was estimated at £ 9 million in 1971.

2.10 The overall level of investment has grown in the 1964-72 period at a compound annual rate of 17.4 percent at current prices to nearly £ 160 million in 1972. The share of the private sector has fallen from 75 percent of investment in 1964 to 62 percent in 1972 (see Table 5). In the enterprise economy, however, the private sector has remained responsible for a slowly falling but very large proportion of investment over the period. Since public investment in the enterprise economy has been largely in electricity and water, transport, storage and communications, and ownership of dwellings, investment in other enterprise sectors is almost entirely in the private sector.

^{1/} Choice of 1972 as a terminal year is unfortunate in some respects, because it was an exceptionally good year for agriculture which grew 17 percent in constant prices. This raises total growth upwards.

2.11 If the allocation of private investment is considered, the most striking feature is the growth of manufacturing's share and the falling allocation to agriculture (see Tables 5 and 7). As might be expected, the share of investment going to electricity and water has fallen sharply as public ownership has increased.

2.12 In looking at the efficiency of the investment in the private sector, we have drawn on the macro-economic work of the mission to calculate net incremental capital output ratios for individual sectors (see Table 12). The methodology of the approach and the implications for economic policy are described at length in Annex 1. Some of the results are of doubtful validity, owing to the nature of the data. But it is interesting to note that the regressions tend to show fairly low NICORS for those private sector activities (namely agriculture, commerce and manufacturing) which together accounted for 70 percent of private monetary value added in 1972. In particular, the net capital output ratio in manufacturing was estimated to be relatively low and falling. On the other hand, the time trends in some sectors, such as building and construction, have been disturbing and are the subject of some discussions elsewhere in the report.

2.13 Since the private sector is judged in large measure by its contribution to employment, it is particularly useful to examine this aspect of performance. An examination of the various sources of information on employment reveals two important phenomena. The first is the decline in the absolute number of employees in agriculture which is described elsewhere in the report. The second - and much more disturbing feature of past performance - is the very slow growth of private wage employment. Since 1964, wage employment in the modern sector, for example, has grown at an average rate of only 1.2 percent a year, while since 1967 total private wage employment has grown at only 1.4 percent.

2.14 At first sight, these dismally low growth rates (which are much below the labor force growth rate) appear to be due to the diminished importance of employment in agriculture, which even in 1972 accounted for over 60 percent of all private employment. It is true that other sectors of the modern sector achieved higher employment growth rates between 1964-72 - for example manufacturing (5.1 percent), building and construction (12.3 percent), and transport and communications (6.3 percent). Tourism has also grown rapidly with direct employment reaching 11,600 in 1971. Yet an analysis of the output-employment relationship within the individual sector shows rather disturbing evidence of a negative trend in all the six major sectors of the enterprise economy:

PRIVATE MODERN SECTOR EMPLOYMENT PER £ 1,000 VALUE ADDED

		<u>trend per annum</u>
Agriculture	3.73	-0.21
Mining	1.94	-0.15
Manufacturing	1.77	-0.06
Commerce	1.43	-0.09
Transport	1.75	-0.14
Services	<u>3.30</u>	<u>-0.14</u>
Total	2.57	-0.13

Source: Table 13

2.15 These trends were calculated from an equation of the employment-output ratio on time and of the elasticity of employment with respect to output. It is particularly significant that the trend towards declining rates of growth in employment are most noticeable in those sectors (agriculture and services) in which the ratio of employment to value-added is presently highest. ^{1/}

2.16 The striking relationship between employment and growth is confirmed by the following figures, which show the elasticity of modern sector employment, with respect to output, for five major sectors:

ELASTICITY OF PRIVATE MODERN SECTOR EMPLOYMENT
WITH RESPECT TO OUTPUT

Mining	0.2
Manufacturing	0.5
Building	1.3
Transport	0.6
Services	<u>0.3</u>
Total	<u>0.1</u>

Source: Table 13

Agriculture and commerce are not shown because they have negative elasticities - that is, their employment has fallen with increasing output. Other activities, with the exception of building and construction, have elasticities of less than one; in view of its importance to the economy, manufacturing's elasticity of 0.5 is especially interesting. Thus, with only one exception, employment growth has lagged far behind output increases, or has

^{1/} These tables are purely descriptive. Quite different explanations can exist, such as increasing capacity utilization, capital-labor substitution, or costless improvements in labor productivity.

declined absolutely, in every section of the private sector. The overall elasticity of private sector employment, at 0.1, indicates the dimensions of the problem. These figures define a situation, which may be insoluble, but they also demonstrate rather starkly the growth requirements, on current trends, of a significant rise in modern sector employment. 1/

2.17 To sum up: The description of salient features of the Kenyan private sector indicates its importance to the economy in terms of output, investment and employment. It provides some information on its performance which indicates no startling transformation of the situation but a fairly steady advance. The one important problem which is highlighted is that of employment, whose responsiveness to output changes is very low. More detailed understanding of the private sector's performance and operation will follow from the discussion of key policy issues.

1/ The current trends may not continue. If the low employment growth has been caused by increasing capacity utilization or costless productivity increases, it is at least probable that future performance will be better.

CHAPTER 3. PRICE SIGNALS AND PERFORMANCE

A. INTRODUCTION

3.01 In this chapter, we shall be concerned with the way in which the private sector responds to the whole range of price policies which affects the costs of its inputs and the price of its products. In the following chapter, we shall turn to the direct controls which have been imposed on the economy by the Government, and we shall analyze their consequences. These two areas - price signals and controls - are the major ways in which the Government can influence the environment in which the private sector operates and, through them, manipulate the behavior of the private sector. Much of the argument of this annex will show that both the price signals and the range of controls will require modification if the private sector is to perform better. We shall also wish to demonstrate that, over a wide range of action, manipulating prices and imposing controls can be alternative ways of achieving the same desired objective, one being an indirect means of using market forces and the other being a direct restriction of entrepreneurial freedom.

3.02 As a general rule, the Mission believes that the use of the price system is the most appropriate way of orienting the private sector in an efficient direction. There are two reasons for this. The most general is simply that, as a long term policy, controls have proved to be a rather costly and inefficient way of influencing profit-oriented activities, not only in Kenya but in most countries that have tried them. The attempt to make entrepreneurs do what is against their financial interest seldom works except in the most disciplined societies and is often counter-productive. The second reason relates more directly to Kenya. A system of controls requires a large, honest, sensitive and flexible bureaucracy. Kenya would have to commit a large proportion of its scarcest resource, skilled manpower, to achieve such an organization. It is not obvious that this is an appropriate way to use these skills. At the same time, it is clear from experience with the trade control system that the present bureaucratic machine is not able to cope satisfactorily. For these reasons, use of the price system seems appropriate for Kenya.

3.03 Price signals embrace a very wide field indeed. The areas concentrated upon in this annex are trade policy, wages and the pricing of credit. This is itself quite wide enough! There are interrelations between these areas, and, in combination, a set of distortions are created which impede the efficient operation of formal non-agricultural activity and create indirect external costs for the rest of the economy. These three areas have been independently analyzed in several research studies, which are used as sources for this analysis. We do not attempt to add to these studies, but, rather, an attempt is made to pull into a coherent whole what is known about

the overall situation and to identify the policy options which are open to the Government. Not only is this a fruitful way of discussing policy, but it is also a useful way of understanding what is happening in the private sector.

B. CURRENT POLICY AND THE PRICE ENVIRONMENT

Trade Policy and Protection

3.04 Past Developments in Trade The basic aim of trade policy has been import substitution. In the Development Plan 1970-74, for instance, there appears the statement "...the Government believes that the country has not yet exhausted all opportunities for import substitution industries. In the last five years, there has been a considerable amount of import substitution and this trend will continue in the next five years." 1/ At the same time, there is no mention of exports among the seven 'targets' of manufacturing.

3.05 The policy has not been very different from those of many of Kenya's neighbors. There is the important difference, however, that on the establishment of the East African common market in 1967, Kenya had a head start in many industries, including those for which there is natural protection, such as brewing and cement, and those requiring high tariff protection. Because of the head start, Kenya's trade structure differs from that of many African countries in having quite a high proportion of manufactured exports, the greater part of which go to Uganda and Tanzania. However, although the proportion is rather high, the rate of growth has been low.

3.06 The Kenyan economy has now largely completed the first phase of import substitution, namely the replacement of consumer goods. The pattern and extent of import substitution is shown in Table 15. 2/ By 1970 only 28.2 percent of domestic consumption was supplied by imports; nevertheless, Kenya still remains dependent on the outside world for most of her supplies of intermediate goods (61%) and capital goods (68%). 3/ The table also indicates the classic tariff structure, with average nominal duties falling from 29.6 percent on consumer goods to 18.0 percent on intermediates, and 12.7 percent on capital goods.

1/ Development Plan 1970-74, pp. 304-5.

2/ The classification used in this table is not entirely satisfactory. In particular, the locations of ISIC Code Nos. 313, 319 and 383 may be incorrect. The table follows Dr. S. Guisinger's classification for Ethiopia in his Tariff and Trade Policies for the Ethiopian Manufacturing Sector and thus preserves comparability.

3/ By comparison, Guisinger showed that Ethiopia imports 30% of her domestic consumption, 50% of intermediate goods, and 87% of capital goods.

3.07 The success of the policy of import substitution is also shown by the changing structure of imports (see Table 16). The average rate of growth of imports has been 10.9 percent per annum from 1964 to 1972. Consumption goods for household use have grown least, by 6.4 percent per annum, and government imports and capital goods most, by 17 percent per annum and 15.5 percent per annum respectively. Intermediate goods imports have grown at virtually the same average rate as imports as a whole. The effect of this has been a reduction in the share of household consumption goods from over 27 percent in 1964 to 20 percent in 1972, and an increase in the share of capital goods from 14.5 percent to 20 percent.

3.08 In 1970 Kenya exported a little over 18 percent of the total domestic supply of processed goods. About half the exports went to Tanzania and Uganda. The structure of Kenyan exports to the rest of the world is fairly typical of a developing country. In 1970 over 60 percent of exports were of non-processed raw materials and foodstuffs (mostly coffee and tea) and only 12.5 percent were of manufactured goods. (see Table 17) On the other hand, 30 percent of Kenya's total exports went to the Community, and over half of these were manufactured goods. Thus, Kenya occupies an intermediate stage in development. It exports primary produce outside the Community, but exports various kinds of processed goods to its partners.

3.09 This pattern may appear, at first sight, not inappropriate to a developing country slightly more advanced than its neighbors. However, there are certain inherent weaknesses in the situation. Kenya is vulnerable because of its relative dependence on exports of consumer goods to Uganda and Tanzania, not only because these kinds of goods are the easiest to replace, under Tanzania's and Uganda's own program of import substitution, but also because the Treaty itself provides mechanisms (through the transfer tax and the operations of the East African Development Bank) to assist this process.

3.10 The average rate of growth of exports from 1964 to 1972 has been 6.8 percent a year, which is almost identical with that of GDP. Within that total however, the share of manufactured goods has fallen from 25 percent to 20 percent, and the growth of manufactured exports has been only 4.1 percent per annum. The largest contribution to increased export earnings has been tea, which has grown at an average rate of 12.5 percent. Only one major export has grown more rapidly, and that is the products of the Mombassa petroleum refinery, but the export statistics overstate the real contribution of refined oil products, since the domestic value added in oil refining is very low - only 16 percent in 1970. Thus, in terms of the 'true' contribution to the balance of payments, Kenya's major success in commodity trade has been tea! Direct expenditures by tourists were £ 26.5 million in 1972, which makes tourism larger than any other single foreign exchange earner. The increase was 280 percent over 1965, or a compound average, annual growth rate of 21 percent. Thus tourism has been Kenya's greatest post-independence success among foreign exchange earnings activities.

3.11 The share of the East African Community in total exports has been falling, from 36 percent in 1964 to 30 percent in 1970 and less than 27 per-

cent in 1972. (The latter figure is perhaps not typical because of the exceptionally low level of exports to Uganda in that year.) Part of the reason for the poor performance of manufacturing is the fact that EAC trade has fallen in proportion to the whole, and well over half of all manufactured exports go to the community. However, there are more disquieting features within the pattern of exports to the EAC.

3.12 If one looks at the pattern of exports since 1964, it is clear that manufactured exports to the EAC have virtually stagnated (see Table 17). There have been sharp falls in the export of the simple import substitutes - particularly processed foods, clothing and footwear - which Tanzania and Uganda are increasingly producing themselves. Allowing for the effect of import substitution in these three categories, together with the falls in base metal exports, it is estimated that Kenya lost some £ 5.7 million in export revenues to Tanzania and Uganda between 1964 and 1972. This loss in export markets has been almost exactly offset by increases in chemicals, paper and metal manufactures and, particularly, petroleum products. Thus, overall, Kenya has been running very hard to stand still in its trade with its partners, which accounts for so much of its total trade in processed goods.

3.13 The picture in relation to trade with the rest of the world has been very different. First of all, the overall growth rate has been very reasonable - over 8 percent a year. Second, manufactured exports have been growing much faster than the average - at nearly 12 percent a year, and therefore are a growing proportion of the total. Most export growth to the rest of the world has come from non-processed primary goods, mainly meat, fruit and vegetables, coffee, tea, hides and skins, and raw cotton. Nevertheless, processed goods have been important, especially the processing of local raw materials. Thus some 43 percent of the increased exports have been tinned meat, pyrethrum extract, petroleum products (21% of the increase on its own), chemicals, paper manufactures, textiles, cement, metal manufactures and footwear. Of these, only a very few are really important, namely, petroleum, pyrethrum extract, tinned meat, chemicals and cement. ^{1/} It appears, therefore, that although Kenya remains largely an exporter of non-processed primary commodities to non-EAC countries, it has done reasonably well in processing manufactured exports, as a whole, and has had striking success in a few industries. This is so in spite of the fact that some of these industries are taxed by the protective system.

^{1/} It is interesting to note that, according to M. Phelps and D. Wasow ("Measuring Protection and its Effects in Kenya," I.D.S. Working Paper No. 37), chemicals, cement and pyrethrum extract were all profitable at world prices, and cement and pyrethrum were negatively effectively protected, as were industrial chemicals. No data are given for petroleum.

3.14 The overall picture is, therefore, that the stagnant trade with the EAC, except in petroleum products, has not been fully offset by the higher growth rate of exports of manufactures to the rest of the world, because of the latter's small base, and Kenya has remained largely dependent on a few primary commodities, and on tourism, for its foreign exchange earnings. It is clear that, on current trends, a major change in its overall export pattern demands an extremely high rate of growth of exports to the rest of the world of those manufactured commodities in which it has a comparative advantage, just to offset the stagnation of trade with its EAC partners. Such a high rate of growth will also be necessary if manufacturing is to grow much at all, given the already high level of import substitution. 1/

3.15 The Protective System The main conscious aim of trade policy being import substitution, 2/ the main policy instrument has been the tariff, which is, of course, determined at a Community level. In addition, there has been an increasing use of import controls as protective devices. 3/ Since the import controls have exacerbated rather than conflicted with the effects of tariffs and have many aspects separate from tariffs, the discussion of them is postponed. (However, the discussion of effective protection does allow for the effects of the controls.) It should, be stressed that one of the reasons for their increased use is that they are under Kenya's independent control. Apart from the tariff protection granted by the community, Kenya is able to grant duty rebates and remissions on imported inputs used by exporters. The procedure is slow, however, and not always effective for firms lacking influence. In 1972 duty rebates were 2.6 percent of gross collection of import duties for the EAC as a whole. These would include rebates, granted as a special protective device to producers of goods sold domestically.

3.16 The efficiency of the protection granted by the EAC tariff has been closely evaluated by a number of studies in recent years. 4/ While these

1/ A change in its trade pattern is attractive not only because of the classic export-led growth arguments for manufacturing, but because of the worsening of the terms of trade which follows from the primary commodity concentration. Kenya's terms of trade index moved from 100 to 94 between 1964 and 1972. Although tourism has played an invaluable role, it cannot substitute for a high rate of growth of manufacturing exports in developing the economy.

2/ A detailed analysis of the direction of Kenya's total industrial policy appears in "Industrial Development in East Africa: Progress, Policies, Problems, and Prospects" Volume IV Kenya, IBRD Report AE-12, pp. 15-28; and ILO/UNDP Report, op. cit., pp. 177-202.

3/ D. S. Macrae, Import Licensing in Kenya, I.D.S. Working Paper No. 90, p. 32, "Today the system is such that wherever there is domestic production of a good its importation is almost invariably banned or severely restricted so that the local producer gets as much of the domestic market as possible."

4/ See IBRD Report No. AE-12, op. cit., Volume I, p. 23, R. Reimer "Effective Rates of Protection in East Africa", Staff Paper No. 78, Institute for Development Studies, Nairobi, July 1970; and M.G. Phelps and B. Wasow, op. cit.

studies differ in methodology and in detail, their conclusions about protection are basically the same, and we shall draw heavily upon these studies in this and subsequent sections of the report. For the sake of the non-technical reader we refer only to the general conclusions in this chapter; the technical reader may refer to Appendix 2, "Measures of Protection and Viability" for a description of the methodology used. ^{1/}

3.17 All the studies agree that a considerable and varying degree of effective protection is granted to manufacturing. Such protection may do no more than enhance the profitability of already viable industries, and thus transfer income from the Government or consumers to producers. But effective protection can also have the effect of making unviable industries profitable, and in terms of productive efficiency, it is the latter that counts. Only one of the studies referred to (namely that done by Phelps and Wasow) addressed itself to the question of viability and its relationship to protection. The study comes to three main conclusions: first, that the protective system favors "finishing touch" industries; second, that no relationship emerges between factor intensity and protection, so that there is no reason to believe the system is biased against employment; and third, that there is a significant negative correlation between profitability at world prices and the level of effective protection. This last conclusion would imply that there is a consistent bias against the most viable sectors.

3.18 The Phelps and Wasow study calculates rates of effective protection ranging from -77.5 percent to 172.9 percent and profitability at world prices ranging from -55.9 percent to 208.4 percent. Of the 23 categories defined in Table 15 as consumer goods industries, 10 are unprofitable at world prices, as are 5 of the 14 intermediate goods industries, and 2 of the 11 capital goods industries. Thus, inefficient protection is fairly well scattered, although there is a concentration among consumer goods industries, as might be expected. From a policy point of view, an especially important conclusion of the study is that no simple formulae for industrialization are likely to be very efficient. Some industries processing raw materials are viable, and some are not; some consumer goods industries are viable and others are not. There seems to be no substitute for detailed case by case analysis. For instance, it appears that the following industries are acceptable: truck and bus body building (but not cars), canvas goods, timber products, printing, leather tanning, some (by no means all) chemicals and pharmaceuticals, some agricultural machinery, pyrethrum, wattle, cement and beef. This is a very disparate group, which only detailed analysis could identify. Moreover, several viable export industries, which are potentially taxed by the tariff structure, may not even exist at present.

3.19 What confidence can be placed in these results? As is shown in Appendix 2, no great trust can ever be placed in results for individual

^{1/} See also Appendix 1 for a non-technical explanation. As stated in Appendix 2, since the Phelps and Wasow Study uses direct price comparisons, the effect of import controls is included in the calculations.

industries, especially when an industry is shown to be non viable at world prices. This must always be borne in mind. However, there are problems peculiar to this study. Although it appears thorough, and is apparently based on more detailed production information, as well as more careful price comparisons, than other studies of effective protection, it has one great anomaly, namely the reported inefficiency of much of agricultural processing industry. Since this is unlikely, it suggests that little faith can be placed in individual results, and must also qualify the overall conclusion that average effective protection was 34.2 percent, and average world price return to capital zero, since the former may well be too high, and the latter too low. These question marks spill-over to affect the three main conclusions reported in 3.17.

3.20 At present, there can be no more than a prima facie assumption of inefficiency. There can be no question that the system is potentially capable of leading to inefficiency, and that no checks in the project approval process exist to prevent it. There can also be no doubt that, if not inefficient, the system does lead to a large transfer of income to manufacturers, many of whom are foreign. However, the precise conclusions concerning average protection and world price profitability can be used only illustratively, and the negative relationship between protection and viability is probable, but far from certain.

3.21 A further important aspect of this work has been to study the effective protection inherent in the East African transfer tax system. Table 19 shows that the effects of the tax are considerable. Tanzanian taxes against Kenyan manufactures produce effective rates of protection (EPZ), which rise to 379.3 percent, and eight are over 100 percent. ^{1/} More striking still is the fact that ten out of the twenty industry groups which Kenya exports to its partners are taxed relative to the outside world (using the 'modified' method). This finding explains in part the export behavior observed above, and points out the difficult problem Kenyan manufactured exports face.

3.22 Conclusions on Trade Policy The situation analyzed above indicates Kenya is at a turning point not only because the first stage of import substitution is completed, but because some of the costlier aspects of that policy (and especially the weapon of protection) are becoming evident. Apart from all this is the evident fact that many of the industries established have no apparent comparative advantage, and, having dominated the domestic market, have nowhere to go. The problem is especially sharp, since further blanket import substitution will inevitably mean high cost intermediate and capital goods input for potentially viable industries - especially export industries.

^{1/} $EPZ = \frac{DVA - WVA}{WVA} \cdot 100$ (See Appendix 2).

3.23 There is potential for further import substitution. The ILO/UNDP report recommends several categories of activity for further consideration, ^{1/} and the evidence of Phelps and Wasow shows the following import substitution industries to be profitable at world prices: sugar confectionary, soap, some miscellaneous chemical products, sawn timber, tanneries and leather products, some basic industrial chemicals, some metal products, some non-electrical machinery, and truck body building. All but three of these industries have negative net effective protection at present according to the study if the exchange rate is assumed to be 15 percent overvalued.

3.24 There is also a potential, and a great need, for more manufactured exports, because of Kenya's vulnerable position vis-a-vis its EAC partners, and the inhibiting effects of their transfer taxes and controls. This is also necessary to avoid excessive dependence on primary commodities and tourism, as well as the danger of future balance of payments difficulties. However, many of Kenya's most important present exports seem to have negative net effective protection, and potential exports are also taxed (especially those using domestic materials).

3.25 The situation calls for a major policy review before Kenya finds itself in the middle of a high cost across-the-board strategy of replacement of intermediates and capital goods, which will probably be a coup de grace to prospects for manufacturing exports, and, in the long run, manufacturing development. It must be remembered that, given Kenya's trade structure, it must do very well merely to maintain its momentum in this field.

The Structure of Wages

3.26 In no sense is it the purpose of this paper to rework the field covered by the ILO/UNDP Report. Nevertheless, any discussion of price signals and performance in the private sector cannot avoid consideration of wages and their influence on factor utilization, incentives, and income distribution. In Kenya this is one of the most important aspects of the private sector's environment.

3.27 The earnings structure in Kenya is to be understood within the basic divisions of formal and informal, on the one hand, and rural and urban, on the other. Thus, there are, essentially, four categories. Formal urban employment (and rural also, to some extent), should be seen as further split into unskilled, semi-skilled, and highly skilled. As can be seen in the table below, the differentials between the four basic categories are considerable. Average formal sector pay in the urban sector is twice average earnings in the urban informal sector for the self-employed. Formal sector urban pay for

^{1/} For example, refined sugar, baby foods, knitting mills, cotton fabrics of high quality, wool processing, footwear, clothing, make-up textiles, plywood, wooden furniture, paper products, leather goods, rubber products, vegetable oils and special paints and varnishes. op. cit. p. 182.

an unskilled worker is twice that of a marginal self-employed man in the informal sector and three times the wage paid in the informal sector. Within the rural sector, there is also a large differential between wage employment in large and small farms. Finally, within the formal sector, pay in the urban areas is substantially above that in rural areas.

DATA ON AFRICAN ADULT EARNINGS IN KENYA, 1969

	<u>£ per year</u>	
	<u>Males</u>	<u>Females</u>
<u>Rural</u>		
1. Average large farm regular employee <u>/a</u>	73	46
2. Average small farm regular employee <u>/a</u>	41	34
3. Average small-scale non-agricultural enterprise regular employee <u>/a</u>	67	49
4. Self-employment: Smallholders <u>/a</u>	113	...
Owners of non-agricultural enterprises <u>/a</u>	130	...
<u>Urban</u>		
5. Average employee formal sector <u>/b</u>	250	185
6. Statutory minimum wage in formal sector, Nairobi <u>/a</u> <u>/d</u>	105	84
7. 'Unskilled' employee formal sector <u>/a</u>	120	90
8. Average self-employed informal sector <u>/b</u>	120	100
9. Marginal self-employed informal sector <u>/a</u> <u>/b</u>	60	50
10. Wage earner in informal sector <u>/a</u>	40	36 <u>/c</u>

/a Derived from ILO/UNDP Report.

/b Independent estimate by Scott.

/c Estimated using 19% discount found by G. E. Johnson, The Determination of Individual Hourly Earnings in Urban Kenya, Discussion Paper No. 115 IDS, Nairobi, September 1971.

/d The minimum wage was raised to £ 135 for men and £ 117 for women in Nairobi and Mombasa from September 1, 1973. In other urban areas and municipalities it is now £ 123 for men and £ 111 for women.

Sources: M. FG Scott, Estimates of Shadow Wages in Kenya, Mimeo (it is largely derived from THE ILO/UNDP Report); ILO/UNDP Report, op. cit. p 77.

3.28 These nominal differences exaggerate considerably the differences in real incomes between rural and urban earners. Scott estimates the ratio of the urban to rural price index to be approximately 1.69. Taking this, and various other factors, such as the cost of family separation, he estimates the benefits from the extra wages as below.

BENEFITS FROM EXTRA WAGES PAID ON TRANSFER OF
THE MARGINAL AFRICAN MALE ADULT WORKER
(£ per annum)

Occupation to which Worker Goes (1)	<u>Increase in Disposable Income</u>			Compensation for Change in Conditions of Work (5)	Net Gain of Worker and Family (6)
	<u>Total</u> (2)	<u>Relatives</u> (3)	<u>Worker and Family</u> (4)		
Small farm worker to:					
1. Rural unemployed	-41	-10	-31	-11	-20
2. Urban unemployed (R)	-41	-16	-25	- 5	-20
3. Urban informal (R)	19	0	19	19	0
4. Large farm	30	0	30	0	30
5. Urban formal (R)	75	0	75	45	30
6. Urban formal (R/U)	75	0	75	55	20
Urban informal worker (U) to:					
7. Urban unemployed	-60	-16	-44	-12	-32
8. Urban formal (U)	56	15	41	0	41

Note: R = family left in rural area
R/U = family brought with worker in urban area
U = family in urban area

Source: M. FG. Scott, op. cit. Table 21.

It appears that substantial improvements in real income only occur when a small farm worker moves to a large farm or the urban formal sector, or when an urban informal sector worker moves to urban formal employment. ^{1/}

3.29 It appears there is a large gap between the informal sector (including small-scale agriculture) and the formal sector. Some evidence indicates this gap is growing. Thus, D. P. Ghai ^{2/} showed that between 1960 and 1966,

^{1/} The figures for the gain derived from moving to urban informal activity assume self-employment. On this assumption, the real reward of urban informal activity is lower than for any rural activity apart from wage earning in the small-scale sector to which it is equivalent. However, assuming that the informal activity is wage earning (estimated at £40 per annum), the rewards are less than in any rural activity. This seems the most likely immediate destination for a migrant. Unless these rewards are lower, the standard wage gap models of migration would predict disequilibrium, since workers in small farms can unambiguously increase their expected real income by moving to the towns.

^{2/} D. P. Ghai, Incomes Policy in Kenya: Need, Criteria, and Machinery Discussion Paper No. 66, IDS, Nairobi, June 1968, Mimeo.

"the average total income of farmers has risen at half the rate of unskilled urban workers." No data are available for wages in small farms prior to 1969, but it is known that real incomes per head have risen at a compound annual rate of approximately 1 percent in the agricultural sector as a whole. Real wages in the private formal sector have risen by at least twice that much.

3.30 Within the modern sector the gap between agricultural and non-agricultural wages grew until 1970. By the end of that year the index of average earnings (which has 1964 as the base year) was only 122 in agriculture, compared with 130 in the public sector, 134 in services, 151 in manufacturing and 172 in construction. 1/ Since 1970, the situation has changed. Union pressure and seasonal scarcity have pushed the wage index for commercial agriculture to 153, at the same time as other sectors have experienced stagnant average wages. In 1971 there was actually a fall in average wages in manufacturing, construction, and commerce, presumably due to the Tripartite Agreement (see Table 21). As a result of these contrary movements, the growth of agricultural modern sector wages has virtually caught up with that of the modern private sector as a whole. 2/

3.31 Another important dimension of the wage gap situation in Kenya is the relationship between educational level and wage rates in the formal sector. It is generally recognized that a primary school education is now becoming the minimum standard required for employment, even for many unskilled jobs. Moreover, as the supply of school leavers increases, the minimum standard of entry to formal employment rises. It now frequently requires some years of secondary school. Incremental skill can bring vastly increased income, as is shown in Table 22 and Table 23. Highly skilled formal sector employees can expect incomes at par with European incomes, while an unskilled worker earning £120 per annum is receiving perhaps 10 percent of the European equivalent. Even some educationally qualified people with relatively low skills can earn large multiples of minimum formal sector incomes. The ILO/UNDP Report 3/ mentions several examples: a stenographer in government can earn £489 - £690 per annum. These incomes are not merely large multiples of minimum formal sector wages, but even larger multiples of incomes to be earned in non-formal activity. This is a society in which rewards for qualified people in employment exceeds the returns of all but the most successful entrepreneurs. 4/

1/ Indices of average earnings are very unreliable sources of information, because of possible changes in the proportions of various skill (and wage) categories. This is what is assumed to have happened as a result of the Tripartite Agreement. The lack of detailed information on wages by skill categories through time creates great difficulties in analyzing the labor market in Kenya.

2/ Since average earnings in manufacturing are approximately four times greater than in agriculture, the absolute 'gap' will increase even if the proportionate growth of each is the same.

3/ Op. cit., p. 254.

4/ P. Marris and A. Somerset African Businessmen; A Study of Entrepreneurship and Development in Kenya (London, Routledge and Kegan Paul, 1971) stress this point in explaining the development of African entrepreneurship.

3.32 The relationship between income and education can be summarized in the following way: first, average income is estimated to rise by Sh.36 per month for every additional year of schooling. Second, the public sector is paying much higher salaries than the private sector for those who completed secondary school; for example, the public sector pays an average of Sh.45 per month more than the private sector for a worker with nine years of education. Third, the greatest advantages come to those who complete primary school and have at least some secondary school education.

3.33 These differentials do no longer, if they ever did, make sense in terms of the supply-demand relationship in the labor market. The problem of school-leaver unemployment has become increasingly severe. At all but a few, usually very senior, levels supply exceeds demand at ruling wage rates. Skilled craftsmen and professionals seem to be the categories where excess demand still exists.

3.34 A final important feature of the Kenyan labor market is that, apparently, wages for similar skills are not equated across industries. Turnover in formal sector employment is, not surprisingly, fairly low, and wages are determined through industry negotiations and Wage Councils. 1/ Completely unskilled workers in the formal sector typically earn between Sh.200 2/ and Sh.400 a month. This fact is of considerable importance since it indicates that wages are determined by industry conditions as much as by the labor market. This has important implications for wage policy, if changes in industry conditions are used as a means of altering wages or the rate of change of wages.

3.35 The Causes of the Wage Structure. What we have described above is an extreme form of a dualistic economy, with wages in the formal sector well above those outside it, and wages within the formal sector rising with educational qualifications by more than labor market conditions would seem to warrant. There are many competing, and overlapping, hypotheses to explain these phenomena. At this point, the issues cannot be completely resolved, but some causal relationships can be identified.

3.36 The first factor to explain is the basic dualism between formal and informal sector wages, for similar skill levels, or why formal sector wages are above alternative opportunity costs. There are four main types of explanation: first, minimum wage legislation only applies to the formal sector and is determined by a generally inappropriate concept of a minimum reasonable reward; second, the existence of trade unions in the formal sector not only forces up formal sector wages but also can impose additional costs on employers by, for example, the dislocation of production. Third, some employers may feel it is in their interests to pay more to ensure higher efficiency, lower turnover,

1/ The ILO/UNDP Report discusses the labor relations system in detail. See op. cit. pp. 253-64 and 545-66.

2/ The current legal minimum wage in Nairobi is Sh.225.

and a reputation as a "good" employer, 1/ while, for employers of non-union labor, there is the threat of action if wages get too far out of line with union wages. Finally, the Government may be the initiating factor in some categories because it is not bound by profitability considerations and 'pays itself' as it wishes.

3.37 A basic requirement for testing any of these hypotheses is a household study in which education and skill levels can be isolated. The most complete is G. E. Johnson's, 2/ which used the Nairobi study. He found that estimated hourly earnings varied by type of employment as shown below. Clearly, unionization is a factor, as is government employment for non-union workers. The fact that non-union wages in private employment were much above informal sector self-employed income indicates that minimum wages, which impose a floor at K135 per annum in Nairobi, are very important. (Predicted hourly earnings for the average self-employed 3/ in Nairobi are Sh. 0.46, which implies an annual income of about K50.) Other factors, such as employer self-interest, paternalism, or fear of "threat effects" may affect non-union wages, but these are impossible to separate out.

INDICES OF ESTIMATED HOURLY EARNINGS
BY TYPE OF EMPLOYMENT

<u>Employment Type</u>	<u>Index</u>
Private Non Union	100
Private Union <u>/a</u>	130
Government Non Union	116
Government Union <u>/a</u>	129
Self Employed	48

/a By 1972, 40% of formal sector wage earners were unionized.

Source: G. D. Johnson, op. cit. p. 23.

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- 1/ This is probably especially true in Kenya, where employers in the modern private sector are predominantly non-citizens and employees are mainly African.
- 2/ G.E. Johnson, op. cit. The extent of the benefit of education was derived econometrically. He showed that the marginal benefits of education increase with the level of education (i.e., increasing returns). Thus, moving from five years to seven years schooling increases incomes by 27%, but from nine to eleven by 68%. The income increase due to a move from zero to eleven years education was 366% in Nairobi.
- 3/ Defined by having "mean" characteristics for the other independent variables, which are education (= 5 years), age (= 33 years), arrival (= 20 years before) and tribe.

3.38 In explaining the gap between the incomes of educated and relatively uneducated people, the most important factor is probably Kenya's colonial past. 1/ Most positions involving any high degree of skill were held by Europeans prior to Independence. Kenyans who filled these posts after Independence were, naturally enough, not willing to have the incomes to which they had aspired reduced. Thus, the higher positions remained at European pay levels. This filtered down to less skilled positions, since enormous differentials within the formal sector were not easy to justify. 2/ It should also be remembered that all categories of skilled persons were very scarce in the past, 3/ and that, for skills of the highest level, there is an international market.

3.39 Some of the factors which explain the formal-informal gap such as unionization may also explain the increase in the gap over time. An additional explanation may be that wage bargaining is oriented to profits within an industry. The disparate earnings for similar skills across industries imply that productivity increases are being shared by employer and employee rather than by employer and consumer, as would normally be expected in a labor surplus economy. A 'high profits cause high wages' hypothesis of employer self-interest 4/ would be that highly capital intensive industries will pay more because the benefits of doing so outweigh the small additional cost. There is some evidence of this for industries such as brewing. If these hypotheses are correct, trade policy which would, according to Phelps and Wasow, have raised the average rate of profit in manufacturing by 20.7 percent, if wages were not also raised, may have been instrumental in raising them. However, the existence of any naturally protected high profit sector would have the same effect.

3.40 A final issue in wage developments is whether the private or public sector is the leader in setting high wages levels, or a high rate of growth. The data for average earnings indicate a lower rate of growth of public sector earnings for 1964 to 1972. The Government is not, therefore, the leading sector. Moreover, average earnings in Government in 1972 were lower than those in manufacturing, construction, commerce and transport, storage and communications. 5/ In the recent past (1968-1972), the average wage in the

1/ The ILO/UNDP Report, op. cit., pp. 83-88 presents a fairly full discussion of the effects of colonialism.

2/ Even minimum wage and standards of housing and other services have been influenced by what was regarded as 'decent' in European eyes.

3/ In the mid '50s there was a shortage of all types of workers in the urban sector as a result of the Emergency conditions. This was probably the factor that opened the formal-informal gap for the first time for the unskilled.

4/ A model of employer interest in the effect of wages on worker efficiency is presented in J. King Wages, Efficiency and Labour Market Disequilibrium IDS Working Paper No. 157, Nairobi, August 1972.

5/ See Table 24. The qualifications in interpreting average earnings data must be remembered.

public sector has risen pari passu with that in the private sector. These data, taken with those of Johnson quoted above, would indicate that the Government simply follows the modern sector trend, although it does pay more to non-union employees. The one exception may be in pay to middle level employees with secondary education where the Government appears to set the pace.

3.41 In all, there are more questions than answers. The wage gaps between skill levels and between formal and informal employment probably started because of genuine labor shortages in the 1950's, as well as the colonial system. They have been maintained by minimum wages, and union pressure in the case of unskilled workers, and by convention and perhaps civil service self-interest for educated workers. 1/ Some shortages for skilled workers remain, but not many - certainly not at middle clerical levels. The nature of bargaining in Kenyan industry probably leads to rapidly rising wages in industries with high capital intensity or high growth of productivity. The latter would be especially true if such productivity increases were costless. 2/ This process would increase the gap between formal sector wages and earnings in the informal sector, since the latter absorbs most of the increases in the labor force and thus has difficulty in raising productivity per head. At the same time, another gap is opened between wages paid in highly profitable industries or industries with a high share of profits in value-added and the rest.

Credit Policy

3.42 The third of the major parameters affecting the private sector is credit and its price. Some aspects of the effects of interest rates on the economy as a whole are discussed in Annex 1 and in Annex 2, which also refer briefly to the financial institutions in Kenya. 3/ In this annex, we are concerned mainly with the consequences of credit policy as it affects the private sector, and the direction of lending. Later in this chapter we shall discuss the extent to which credit is preempted by the urban formal sector.

3.43 The most important institutions in Kenya are the commercial banks which, in the British pattern, are largely oriented to financing trade. Their main lending rates have not changed in the past six years, from 7 percent up to perhaps 10 percent. In Kenyan circumstances this has amounted to a real interest rate of approximately 5 to 8 percent.

1/ Highly skilled workers are usually a small proportion of costs, which reduces any pressure to change their wages.

2/ That such increases exist is argued by H. Pack Employment and Productivity in Kenyan Manufacturing IDA Discussion Paper No. 149, Nairobi, August 1972.

3/ For a more detailed review of financial institutions, see B. Dillon Financial Institutions in Kenya 1954-71 A Preliminary Analysis Working Paper No. 61, IDS, Nairobi, September 1972; and Economic Progress and Prospects in Kenya, IBRD Report No. AE-22, March 3, 1973, Annex B. Mobilization of Private Savings.

3.44 Although adequate statistics were not available, it appears that commercial banks direct their funds 1/ from rural to urban areas and, above all, to foreign-owned firms in the formal sector. An indication of this is that, by December, 1971, loans to Africans, although rising rapidly, were only 13 percent of all loans. The Authorities have attempted to restrict the access of the foreign firms to domestic Kenyan finance, which is cheap by international standards. The present regulations limit the borrowing rights of foreign firms to 20 percent of equity. If the local equity participation is more than 50 percent, the borrowing limit may be increased to 40 percent. The development of factoring (now forbidden) and equipment leasing have been ways to evade these restrictions. 2/

3.45 To sum up: two important features of the system of credit mobilization and allocation are noteworthy. First, the real rates of interest charged are quite low and vary very little with risk. Whether the level and spread should be raised depends on the excess demand, actual or potential, for funds. 3/ 4/ In spite of the apparent absence of any unorganized money market it is the implicit view behind several development projects 5/ that there is such excess demand. (On the other hand, the non existence of such a market does raise questions about the desirability of higher rates.) Whatever the situation, real rates should probably not go below those to be earned safely abroad. Second, the banking system, which is a major means of fund mobilization, channels funds away from the rural economy towards the urban formal expatriate sector. This question will be examined later.

1/ Commercial banks mobilize about 30 percent of Gross Domestic Savings.

2/ At present rates of interest, there is a considerable incentive for foreign firms to borrow domestically rather than abroad. This leads to problems in implementation of the controls.

3/ The existence of actual excess demand would imply a resource gap problem, while potential excess demand would mean that good opportunities are being lost. Correction of the latter would require institutional reform.

4/ It can be argued that the domestic real rate of interest should never be lower than the real return available abroad, regardless of domestic demand conditions. For the past, the return abroad would have been lower than the 4% - 5% available in Kenya. At this point of time, as Kenya's inflation accelerates and rates of interest elsewhere are high, this argument probably implies that the domestic rate of interest should be raised. (Any excess savings can be invested abroad by the government.) D. Lal, The Return from Foreign Investment and the Lower Bound of the Accounting Rate of Interest, IBRD Draft, April 1973, argues for a lower limit of 4% (real) on the basis of international returns.

5/ In rural credit, for instance.

C. THE EFFECTS OF CURRENT POLICY

Introduction

3.46 The review of the environment of the private sector highlights certain crucial distortions. Granted all the qualifications to be made in interpreting effective protective rate calculations, there seems to be a distorted trade policy environment which exacerbates an already difficult trade situation. Current wage policy has got out of line with demand-supply relationships in the labor market, has led to possibly disproportionate differentials between skilled and unskilled, rural and urban, formal and informal sectors, and different levels of education. Finally, the banking system offers what is probably excessively cheap credit to a selected few, largely expatriate urban customers. In what follows, the direct effects of this 'package' on the urban formal sector is considered. Subsequently, we shall turn our attention to the indirect effects of present policy on the rest of the economy.

Effects on the Formal Sector

3.47 Factor Intensities The most celebrated consequence of an environment of the type considered above is on factor intensity. The low interest rates, cheap imports of capital goods because of low duties and an overvalued exchange rate, and finally the high wage rates in the formal sector create an environment which a priori might be expected to raise capital output and capital labor ratios. This could possibly be an explanation for the extremely disappointing employment effects of the growth of the formal sector so far recorded. It should be stressed, however, that the data available do not permit any easy conclusions. In particular, there is no useful information on the capital stock which would be necessary for any careful work on the effects of factor prices on factor intensities.

3.48 From the analysis carried out in the last chapter, it appeared that a significantly rising incremental capital-output ratio is observed only in 'other services' among major private activities (see Tables 12 and 13). Agriculture, manufacturing and wholesale and retail trade have either insignificant trends or, in the case of manufacturing, strongly negative trends. At the same time all these sectors have falling employment-output ratios. 1/ This combination appears to indicate an increasing efficiency of labor use, which can either mean a greater application of non-enumerated factors such as human capital, or a more efficient use of labor or capital, or both. 2/

1/ These sectors accounted for 90% of modern sector employment in 1971.

2/ Falling capital-output and labor-output ratios indicate greater efficiency in the use of both capital and labor. Constant capital-output ratios, combined with falling labour-output ratios, would indicate greater efficiency in the use of labor. The evidence outlined above is consistent with the assumption of Harrod neutral labor-augmenting technical progress. The rough constancy of the share of wages in modern private sector value added would support the assumption.

3.49 Equations showing the relationship between changes in average wages in the private sector and changes in average productivity were estimated by Harris and Todaro^{1/} for 1955-1966. The coefficient of 0.761 which they estimate is the wage elasticity of demand for labor, assuming no effect on output but merely on factor proportions.^{2/} This coefficient is, in their view, not significantly different from unity. Our own estimates would indicate a somewhat higher elasticity since the estimate of the elasticity of substitution between labor and capital is itself unity. In any case, a strongly significant positive relationship between rising wages and output per man is indicated.

3.50 Essentially, two main hypotheses can be advanced. Harris and Todaro argue that higher wages actually lead to increased labor productivity, since employers are encouraged to augment labor by training unskilled workers, ^{3/} substituting skilled workers and improving organization. Because these improvements are not costless, their effects are seen to be related to the wage. Interestingly enough, Harris and Todaro support the view advanced above that there has so far been no significant increase in capital intensities as a result of rising wages.

3.51 An alternative thesis, advanced by Pack,^{4/} is that the wage increases are a consequence, not a cause, of rising productivity. He argues, on the basis of detailed interviews, that techniques in Kenya are fairly

1/ J. R. Harris and M. P. Todaro, Wage Policy and Employment in a Developing Economy, Discussion Paper No. 72, IDS, Nairobi, November 1968. Their equation for African workers was:

$$P = 1.78 + 0.761W \quad R^2 = 0.703$$

(SE=1.60) (SE=0.17)

where P = rate of change of productivity per head
W = rate of change of wages per man

2/ Assuming a C.E.S. production function - the elasticity of employment with respect to the wage = $\frac{-S}{1-W}$

where S = elasticity of substitution between labor and capital
W = share of wages

Our own estimates of the equation (see Table 26) $\log \frac{V}{L} = a + b \log (W)$

give an estimate of b (=S) not significantly different from unity. In this case the elasticity of employment with respect to the wage must be about two, since labor's share in modern private sector value added is less than half.

3/ "We believe that the most important source of productivity increase has arisen from training workers and upgrading skills." op. cit. p. 18.

4/ H. Pack, op. cit.

labor intensive 1/ especially in ancilliary process (such as handling of goods). However, skilled managers are able to achieve productivity improvements almost costlessly. The rising productivity leads to pressure for high wages, which firms are prepared to grant, for reasons considered above (para. 3.36). There is a limit to such disembodied productivity increases, however, beyond which wage pressure would require a greater input of capital. Since, as he argues, there exists a wide range of techniques in most industries (largely because all processes include some sub-activities where choices exist), this would be possible. Alternatively, assuming reduced wage pressure, future output growth will generate more employment than has been the case in the past.2/

3.52 On the basis of the evidence so far to hand there is no possibility of making a final discrimination between these two hypotheses. Indeed it is not difficult to imagine both processes acting at the same time: that is, that rising real wages may be both a cause and a consequence of increasing productivity. In any case, the process of rising wage rates will not be sustainable without rising capital intensities or further labor augmentation and correspondingly a lower rate of growth of employment than might otherwise be achieved.

3.53 The great weakness of this analysis is that it is concerned with a process, namely, changes in techniques associated with changes in wages. However, many of the most important questions concern the effects of a price and policy structure.3/ For example, what labor intensive industries or techniques have never been considered because of the relative price of labor and capital? Is there a relationship between trade policy and factor intensity because import substitution ties production to a certain demand pattern and imports from developed countries are likely to be capital-intensive? Do quality requirements predetermine technique? Answering these questions is more difficult since they are hypothetical. However, comparative analysis indicates that ICORs themselves are not especially high. 4/

3.54 There does exist a little evidence on the relation between the protective system and factor intensities. Phelps and Wasow5/ correlated the

1/ H. Pack argues (pp 2-3) that Kenyan techniques in paint production and cotton textiles, in particular, are labor intensive by international standards. His evidence does, of course, only apply to manufacturing.

2/ He argues that improvement in capacity utilization have been important in lowering capital-output and labor-output ratios but that these will also reach a limit after a while. He presents no evidence for this assumption, which is further discussed below.

3/ The concentration on wages in discussion of the effects of relative prices on techniques over time is made logical by the fact that, in Kenya, trade policy and the interest rate have been relatively static.

4/ The ICOR for manufacturing was estimated at 2.5 and falling.

5/ Phelps and Wasow, op. cit., p. 22.

level of effective protection with capital-unskilled labor ratios. They found no significant relationship. However, since their measures of the increase in the rate of return due to protection and of capital labor ratios use very dubious capital stock data, they may underestimate the protective effects of cheap capital, as opposed to cheap intermediate inputs. In that case the results are not trustworthy.

3.55 One possible effect of the policy system would be to encourage greater capital intensity in large firms than in small ones, mainly because large firms are likely to have privileged access to cheap finance. The 1967 Census of Industrial Production, which was the only survey to cover firms employing less than fifty people, provides some relevant information. First, the share of wages in value added is approximately the same in all sizes (56% for firms employing more than 50 people, 58% for firms employing 20 - 49 people, and 56% for firms employing 5 - 19 people). Second, the share of depreciation in value added, which, under fairly strict assumptions, is a proxy for the capital intensity, fell from 13 percent in the largest category to 7 percent in the smallest firms. These data certainly indicate a higher rate of profit in small than large firms, which is consistent with the thesis that the cost of capital is higher. The labor-output ratio and the wage may be the same as in large firms, or the wage may be lower and the labor-output ratio higher^{1/}. In both cases the capital-labor ratio would be lower.^{2/}

3.56 To summarize: the data do not indicate much deepening of physical capital in the formal private sector. However, there does seem to have been a process of labor augmentation which caused or was caused by rising real wages. The result has been very slow labor absorption. However, continued rising real wages would almost certainly lead to rising physical capital intensity in the future. There is no evidence that trade policy has affected capital-intensity, although this is possible.^{3/} There is also no evidence that physical capital intensity^{4/} is very high in Kenya, although it is always possible that some labor-intensive industries and processes have been precluded. Finally, there is evidence of lower capital intensity in small-scale industry, without lower shares of profit in value added.^{5/}

^{1/} The thesis that the wage is higher in small industry than large is extremely unlikely.

^{2/} See on this L.P. Mureithi, A Framework for Analysing Labour Absorption Capability for Different Firm Sizes in Kenyan Manufacturing, Working Paper No. 75, IDS, Nairobi, December 1972.

^{3/} In a world of biased substitution between factors and intermediates, all evidence based on effective rates of protection calculations breaks down.

^{4/} Average capital requirement per job in manufacturing has been estimated at £2,000 by the ILO/UNDP Report, op. cit., p. 446.

^{5/} This situation is always possible with sufficiently fragmented labor markets (i.e., wages are not equated across industries) and production functions with elasticities of substitution less than or equal to unity. It implies that theories which assume highly capital intensive industries entail high profits and high savings break down at the first step - i.e., they require constant wages for given skills, or $\sigma > 1$. A simple hypothesis which would nullify the theory is that wage rates are a function of profit shares.

3.57 Capacity Utilization The evidence discussed above is consistent with rising capacity utilization over time, and rising capital output ratios in new investment, the two offsetting each other. There is no evidence on this trend. However, the IBRD Report on industrial prospects in East Africa,^{1/} and the ILO/UNDP^{2/} Report do discuss some recently collected evidence. The IBRD report concluded that capacity utilization was not as serious a problem as in other developing countries. The ILO/UNDP Report concurred with this overall judgement. Their conclusions were based on a recent study^{3/} which showed that total gross product would have been 11 percent higher if all firms had been operating at their own desired levels of capacity utilization and 100 percent higher if they had achieved 140 hours a week. Thus capacity utilization appears not to be optimal.^{4/} There is no reason to suppose levels have changed in any consistent way over time.

3.58 Several hypotheses can be advanced - some of them supported by the preliminary results of the survey. The first is that labor costs more at certain times of day because of unwillingness to work or lower efficiency; a second is that there exist indivisibilities in plant; a third is that a firm wishes to get a jump ahead of its competitors by exploiting potential monopolies guaranteed by protection. Evidence for all these factors does exist, although it was the view of the IBRD mission that "in general, machinery and equipment has been well selected to produce limited production runs economically." This indicates the second explanation may not be very important.

3.59 According to the same study, capital utilization in Kenya is very sensitive to trade policy. This is for two reasons. First, trade policy alters factor price ratios in favor of capital, which makes it cheaper to leave capital idle; second, import substituting firms are constrained by market size. In addition, particular problems have occurred in the recent past because firms whose production was oriented to the entire East African market have found themselves restricted to Kenya.^{5/} Another difficulty has been the growth of restrictions on current transactions.^{6/} Thus, although there is no data on the trend, it does appear that the level of capacity

^{1/} IBRD Report No. AE-12, op. cit., p. 31.

^{2/} ILO/UNDP Report, op. cit., pp. 182-4.

^{3/} The major source is a study being carried out by The Statistics Division of the Ministry of Finance and Economic Planning, in cooperation with the IDS, Nairobi. A preliminary report appears in: Mary Ann Baily, Capital Utilization Rates in Kenya Manufacturing: an Interim Report, Working Paper No. 66, IDS, Nairobi, October 1972.

^{4/} The word 'appears' is used advisedly.

^{5/} One example observed by the mission was the manufacture of bicycle tires.

^{6/} See Chapter IV, Controls on Trade and Foreign Exchange, for a more complete discussion.

utilization is not as high as it could be. The entire environment, but especially trade policy, seems to be responsible for this situation.

3.60 The Taxation of Exports Although this theme appears under our discussion of trade policy, it is particularly important to the operation of the formal sector. Exports of goods produced within the formal sector are taxed through the trade policy structure because of the raising of the price of inputs and also through the high wages. The dual wage structure may itself be the product of the trade policy system, but it taxes any activity separately. Since the share of wages in value added in industry is over 50 percent 1/ in Kenya, an excess wage (over opportunity cost) of 25 percent is an important factor in determining profitability.

The Balance of Payments

3.61 A policy system of the kind discussed above has certain fairly well known consequences for the economy as a whole, some of which can be documented for Kenya and the others cannot be. The first is for the balance of payments. On the basis of the formula used by Phelps and Wasow and their average effective rate of protection, it is estimated that world value added is about 66 percent of domestic value added for manufacturing. 2/ This has two major consequences. First, policy which continues on these lines saves very much less foreign exchange than appears to be the case. 3/ For example, an increase in manufacturing value added of £ 100 would save not US\$280 in foreign exchange as the present exchange rate indicates, but only US\$184. Thus, the balance of payment consequences of manufacturing growth with an import substitution bias are

1/ It is interesting to note that this share is exceptionally high. See I.M.D. Little, T. Scitovsky, and M. Scott, Industry and Trade in Some Developing Countries, OECD Paris, 1970, p. 45, Table 2.2.

2/ Derived from:

$$\frac{DVA - WVA}{DVA} = .342$$

$$WVA = 0.658 \text{ DVA}$$

3/ See S.R. Lewis, Jr. The Effects of Protection on the Growth Rate and the Need for External Assistance Center for Development Economics, Williams College, Research Memorandum No. 49, which discusses this problem exhaustively.

by no means as favorable as they appear. 1/ On the other hand, £ 100 of value-added in exported commodities like tea generates the full US\$280 (discounting the small demand elasticity effect). Second, the growth of manufacturing at world prices is substantially below that in domestic prices. Taking the growth of private sector agriculture and manufacture 2/ between 1964 and 1971 in constant prices, we observe an increment of £ 20 million and £ 21 million, respectively. However, if it is assumed that agriculture's effective rate of protection is zero (which is probably an overestimate -- its e.r.p. is probably negative), and manufacturing's is 34 percent, the figures in terms of foreign exchange generation are £ 20 million and £ 14 million respectively 3/. Thus, manufacturing's contribution in terms of foreign exchange earning or saving is substantially less than that of agriculture.

3.62 Apart from the obvious effects of encouraging inefficient import substitution and taxing viable exports, the system can reduce the use of domestic raw materials. The effect works in the following way: because the tariff system will lower the equilibrium price of foreign exchange (perhaps by about 15 percent in Kenya), any imported input whose nominal tariff is less than this will become cheaper relative to domestic goods. Thus, there is an incentive to use imported low duty inputs rather than domestically produced non-tradeable goods. 4/ This will affect choice of both industry and technique. Domestically produced tradeable inputs will not be penalized in use if there are low tariffs on imported substitutes, but their production will be less profitable, at least by the extent of the exchange adjustment. 5/ Finally, goods using protected inputs will also be taxed and be less likely to expand. (Examples in Kenya are industries using pulp and paper products, or tires, or several other intermediates now produced under protection.)

3.63 This last effect of protection is what makes the "second stage" of import substitution so lethal, because it encourages the production of highly

1/ This ignores, of course, the problem addressed by cost-benefit methodologies such as Little-Mirrlees, namely the incremental consumption out of additional factor incomes and its balance of payments effect. However one effect should be stressed, namely incremental profit expatriation. This reduces foreign exchange savings still further.

2/ These are the major traded goods sectors.

3/ This phenomenon is well documented in 'Industry and Trade in Some Developing Countries - A Comparative Study' Ian Little, Tibor Scitovsky, and Maurice Scott, OECD 1970 pp. 70-76.

4/ If the nominal rate of tariff on a tradeable good is less than the equilibrium exchange adjustment, that good becomes relatively cheaper than non tradeables after the system is put into effect. In Kenya this applies to most capital goods and intermediates.

5/ At this point the relevant concept is net effective protection or effective protection after allowing for the effect of the tariff system on the exchange rate.

protected intermediates and capital goods. 1/ These tax all industries using them. The costs of such a development do not depend on the activity being inefficient, but merely on the price of output being substantially raised above the world price. At the three-digit level such industries already exist in Kenya. Thus, development is likely to involve fewer domestically produced input-linkages, either because they are non-tradeable and thus more expensive than low-duty tradeables, or because they are low-duty tradeables and thus unattractive to produce, or because they are high-duty tradeables and thus unattractive to use. These factors may explain, in part, the low value added in Kenyan industry (an average of 29.8 percent in 1970) and the apparent lack of vertical integration.

3.64 Low vertical integration leads to the phenomenon of import dependency. As has been noted above, the structure of Kenyan imports is shifting towards inputs, as consumer goods are substituted for. (Table 20 shows how high the import intensity of production is.) 2/ In balance of payments crises, such as that of 1971, the first impulse is to cut "inessential" imports of consumer goods -- in that case by controls. This step further increases the weight of inputs in the import bill and thus the vulnerability of production levels (which depend on imported inputs) to remedial action in the face of subsequent balance of payments crises. Moreover, the import controls further increase the incentive to substitute for inessential consumer goods while making the inputs for their production 'essential'. In this way, a vicious cycle of balance of payments crises and controls is started. Each successive crisis is more difficult to control than the last because there is progressively less left to cut. Moreover, the further the protection system develops, the more heavily taxed export earning power becomes. Kenya, after the 1971 crisis, is at the very beginning of this process.

3.65 Another important effect of the strategy is on revenue from tariffs. As imports shift from highly taxed consumer goods to low-duty intermediates and capital goods, tariff revenue becomes less elastic. Thus, in Kenya, the ratio of import duties to net imports shows a downward trend in spite of higher rates imposed from time to time. In 1964/65 the ratio was 19.2 percent, but it had fallen to 17.2 percent by 1971/1972. The tariff structure at present in force will inevitably lead to declining revenue ratios as the more highly taxed consumer goods are all replaced.

The Taxation Effect on Agriculture

3.66 There are two main sectors producing traded goods, agriculture and manufacturing. Since manufacturing is protected (or subsidized) in the domestic

1/ From the point of view of the user, the crucial rate of protection is the nominal. This determines the extent of the difference between world and domestic prices. The table 'The Pattern of Import Substitution, 1970' shows how many industries in the Intermediate and Capital Goods Industries have high nominal rates of protection.

2/ The section above shows how small the true foreign exchange saving of import substituting production can be.

market, agriculture is correspondingly anti-protected (or taxed). 1/ Since most agricultural output is tradeable, and its world price is fixed, the anti-protection occurs through raising the price of protected inputs, and of goods which farmers buy for consumption. In other words, the terms of trade are shifted against farmers. The effect is exacerbated if non-tradeable goods used by farmers, or factors of production like labor, become more expensive in relation to tradeable goods through maintaining an exchange rate at a higher level than would be sustainable under a free trade system. This effect would worsen profitability, even if the relative prices of tradeables in agriculture were unchanged. 2/

3.67 The effect on the rural-urban terms of trade can be assessed in various ways. One of the simplest is to use factors to convert agricultural production and consumption into foreign exchange equivalents. M. Scott has estimated these for rural consumption as a whole, and for the marginal product of small and large farm workers. 3/ The latter can be taken as estimates of the ratio of the value in foreign exchange to the value in domestic currency of a typical bundle of small-farm and large-farm production. These ratios are given as 1.02 and 1.10, respectively. They imply that for every £ 1 received by these farms £ 1.02 and £ 1.10 worth of foreign exchange are being earned at ruling exchange rates. 4/ The ratio for consumption on the other hand is 0.9, which implies that the cost of £ 1 of consumption is only Sh 18 at ruling exchange rates, or US\$2.52. Thus, a farmer who earns £ 1 and spends £ 1 in domestic currency is, in fact, earning US\$2.85 or US\$3.08 and spending US\$2.52. The deterioration of the terms of trade from those obtaining in free trade (assuming identical production and consumption patterns, and world prices) is from 100 to 88, or from 100 to 82, respectively, where 100 is the world price terms of trade. 5/

1/ The 'extra' income received by manufacturers has to come from someone else. A large country might tax foreigners (because of inelastic supply curves), but a small country can only tax exports, in general, and agriculture in particular.

2/ Any such effect would, however, not worsen the terms of trade for agriculture as a whole but merely shift the distribution of income in agriculture between labor and employers. For the smallholder who farms himself the effect is irrelevant, of course.

3/ M. FG. Scott, Op. Cit., p. iii.

4/ An alternative way of putting it is that, if £ 1 = US\$2.80 at the official exchange rate, the farmers are actually earning US\$2.85 and US\$3.08 for every £ 1 received.

5/ This ratio is defined as $= \frac{C_f \cdot P_d}{C_d \cdot P_f}$

where C = consumption
P = production
f = foreign prices
d = domestic prices

3.68 Until recently, there was no sales tax in Kenya, so that the bulk of the differential is due to the fact that some agricultural exports are taxed (for instance coffee pays exports taxes), various other agricultural commodities have domestic prices fixed below the border price -- an important current example being meat -- and, at the same time, many manufactured goods are protected. The "revenue" generated by the "taxation" of agricultural producers is divided between the government, urban consumers, and urban producers. The greater the proportion of rural consumption going on domestically produced goods, the greater the proportion of the "tax" going to urban producers. Similarly, the greater the proportion of output sold to urban consumers at below world prices the greater the proportion of the "tax" going to them.

3.69 The magnitude of transfers between sectors can be calculated by taking the tax or subsidy per £ 1 of value added, and multiplying by the total value added in current prices. For agriculture the weights of small and large farms in monetary value added were assumed to be proportional to their respective shares in monetary output, which were 43.8 and 56.2 percent, respectively, in 1971. The tax rate was, therefore, US\$0.45 per £ 1, and the total implicit tax on agriculture in 1972 is estimated at US\$41 million. 1/

3.70 A similar calculation can be done for manufacturing where, as we have shown above, the conversion factor on the output side is 0.66, which is the average ratio of world to domestic value added. In other words, for every Kenya pound received by a factor of production in manufacturing, only US\$1.84 is earned. At the same time the conversion factor for urban consumption is estimated at 0.80, which means that US\$2.24 is actually spent for every £ 1 received. The terms of trade have improved from 100 to 122, and the implicit rate of subsidy is 22 percent. The value in 1971 of the subsidy was US\$31 million. 2/

3.71 These figures indicate a large income transfer generated by Kenya's pricing policies in agriculture and its protection to manufacturing. This transfer has three obvious effects which, considering the economic situation in Kenya, are particularly serious. First, since the taxation of agriculture reduces the incomes of the poorest people, the process involves a transfer from the relatively poor to the rich, and leads to a further widening in income distribution between the urban and rural areas. Second, the taxation of agriculture inherent in the system has the effect of reducing the attractiveness of agriculture and rural life as a whole, and thereby exacerbates rural-urban migration and the pressure for formal education. Third, to the extent that

1/ The foreign exchange receipts are used as a base for computing the implicit tax rates.

2/ These calculations are done by taking the dollar tax or subsidy per £1 of value added, and multiplying by the total value added in current prices. The tax per £1 in agriculture was US\$0.45, and the subsidy in manufacturing was US\$0.40.

the system taxes exports, it reduces the number of commodities that can be profitably produced for export, in domestic currency terms. This last factor may be very important indeed in view of the difficulty in expanding income-earning opportunities for the mass of the rural population. 1/

3.72 Since the manufacturing sector has large foreign ownership, 2/ much of the transfer is expatriated as "profit". Indeed this fact entails a qualification to the figure for the subsidy to manufacturing. Profits can be repatriated at US\$2.80 to the Kenya pound, while consumption in urban areas has an implicit exchange rate of US\$2.24 to the pound. Thus, the implicit rate of subsidy to expatriated profits is 52 percent of the average foreign exchange earning of US\$1.84 per E 1 in manufacturing. In other words, for every E 1 repatriated, the profit earner is receiving a subsidy of US\$0.96.

3.73 What is observed above is a system of multiple exchange rates the effects of which are to benefit the foreign capitalist most, and then the local capitalist, and wage earner in manufacturing, all at the expense of agricultural producers. This is the major effect of the protective system.

Migration, Unemployment, and the Demand for Education

3.74 The second major effect of the distorted urban formal sector is on the labor market in the economy as a whole. It is useful to consider two aspects: the first is the effect on the migration of unskilled workers from rural to urban areas; the second is the effect on the demand for education. The formal models have been developed for the first case, but the latter can be fitted in.

1/ The recent IBRD agricultural sector survey pointed out the pressing need to find new cash crops to intensify smallholder production. Since Kenya is already largely self-sufficient in agriculture products, new smallholder production has to be mainly export-oriented.

2/ The ILO/UNDP Report. Op. cit., pp. 441-446, shows that 57% of manufacturing gross product is in foreign-owned firms, and that 42% of capital formation in manufacturing in 1968 was financed by private long-term inflows.

3.75 The discussion of the first problem can be conducted in terms of models associated with J. R. Harris and M. P. Todaro, and subsequently developed and used by others in the Kenyan context. 1/ The basic components of the model are two: first, it is assumed — rightly in the case of Kenya — that there is a gap between wages in the urban formal sector and elsewhere in the economy; 2/ and, secondly, it is also assumed that workers will equate the expected value of a job in the urban formal sector to the wage to be obtained elsewhere. In a very simple model, where the only choice in urban areas is between formal sector employment and open unemployment, formal sector jobs can only be obtained by those in the cities, and the probability of getting a job is the ratio of formal sector employment to employment plus unemployment. Unemployment will then be a function of the wage gap and the number employed in the urban formal sector. 3/ In this kind of model, any increase in the numbers employed in the urban formal sector, or in their wage, will generate more unemployment.

1/ See J.R. Harris and M.P. Todaro, A Two Sector Model of Migration with Urban Unemployment in Developing Economies, Discussion Paper No. 69, IDS, Nairobi, September 1968; Urban Unemployment in East Africa: An Economic Analysis of Policy Alternatives, Discussion Paper No. 71, IDS, Nairobi, September 1968; and Migration, Unemployment and Development: a Two-Sector Analysis, American Economic Review, March 1970. See also H. Rempel, Labour Migration into Urban Centres and Urban Unemployment in Kenya, unpublished D. Phil thesis submitted at the University of Wisconsin 1970; B. Wasow, A Simple General Equilibrium Model of Wage/Exchange Rate Policy in an Open Undeveloped Economy, Staff Paper No. 83, IDS, Nairobi, September 1970; J.E. Stiglitz, Alternative Theories of Wage Determination and Unemployment in LDCs: I: The Labour Turnover Model, Cowles Foundation Discussion Paper No. 335, April 1972; M. FG. Scott, Op. Cit. pp. 82-88.

2/ This model does not do justice to the four sector division that is appropriate to Kenya. Such a situation complicates the model and modifies the conclusions. For instance, the existence of an urban informal sector reduces the extent of open unemployment and also the costs of migration.

3/ If W_{eu} is the expected urban wage, W_r is the rural wage, p is the probability of getting an urban job, and W_u is the urban wage, then:

$$1) \quad W_{eu} = pW_u = W_r$$

Moreover if N_{uf} is urban employment and N_{uu} is unemployment, then:

$$2) \quad p = \frac{N_{uf}}{N_{uu} + N_{uf}}$$

rearranging and substituting:

$$3) \quad N_{uu} = N_{uf} \frac{W_u - W_r}{W_r}$$

which implies that urban unemployment will increase proportionately with urban employment or the wage gap.

3.76 A dynamic model of migration presented by Todaro 1/ can be used to predict the required increase in the annual rate of job creation in the urban formal sector just to keep the unemployment rate from increasing, if there is a widening of the percentage wage gap. Figures for Kenya might be set at 4 percent for urban formal employment growth, 60 percent as the percentage rural-urban wage gap in real terms, and 2 percent for the natural rate of growth of urban population. If the increase in the wage gap were 10 percent, the required increase in the rate of growth of urban employment would be 1.9 percent. Under past experience this would require an increase in the rate of growth of output of at least 3.8 percent. Thus, a small increase in the wage gap (which requires a rise in the urban wage itself of only 3.8 percent) would entail an increased formal urban rate of growth of output of 3.8 percent. This would be a 50 percent increase over past experience.

3.77 Whatever the reliability of specific models, and the simplifications implicit in them, it is certain that the continuance of productivity linked wage increases in a dual economy will lead to a steady worsening of the employment problem. Table 27 shows the growth of the African population in the main towns. Taken against a population growth of 3.5 percent, the implicit migration is very considerable. As the ILO/UNDP Report puts it: "An inflow of job seekers at roughly three times the rate of job opportunities in the formal sector has inevitably made it very difficult to absorb the migrants into production employment." 2/ The result has been marginal informal sector activity, unemployment and frustration.

3.78 The point should not be overstressed. The pull on rural workers may be less than the simple model predicts. Rempel's 3/ econometric study indicated that the rural urban wage gap was not a significant explanatory phenomenon for migration, and Scott 4/ developed a model which predicts that unemployment may rise or fall in response to changes in formal sector employment. However, the basic result, especially with regard to the effects of changes in the wage gap on unemployment, can be accepted.

1/ M. P. Todaro, A Model of Labour Migration and Urban Unemployment in Less Developed Countries, Mimeo p. 11, cited in J. R. Harris and M. P. Todaro, Urban Unemployment in East Africa: An Economic Analysis of Policy Alternatives, Op. cit. p. 11.

The equation is:

$$dG = \frac{-G^2 dA}{GdA - GB - AB - BdA}$$

where G = rate of urban employment growth

A = percentage urban-rural wage differential

B = natural rate of permanent urban labor force growth

2/ ILO/UNDP Report, op. cit., p. 49

3/ Rempel, op. cit.

4/ M. FG. Scott, op. cit., pp 85-86.

3.79 The most important part of the migration induced by wage expectations is on educated people. It also determines the demand for education itself, which, given current wage differentials is an understandable and perhaps rational choice on the part of the individual, if not for society as a whole. These effects are documented in Table 28, which shows that the proportion of male migrants with more than four years of schooling was 75.7 percent in 1969-70, while it was only 12.4 percent in the population as a whole.

Income Distribution and Efficiency Implications

3.80 This area is so complex that little more than indications can be given. However, efficiency is easily dealt with. In an economy where marginal products are generally positive, any unemployment, or voluntary acceptance of a less productive job than is available, will reduce potential output. Kenya is, therefore, working inside the frontier.

3.81 The effects on income distribution between sectors and factors of production depends, in the first place, on whether the economy is open or not. 1/ Assuming an open economy, the high wages in the urban formal sector probably reduce labor's aggregate earnings in that sector, since, assuming a unit elasticity of substitution between labor and capital, the demand for labor will have greater than unit elasticity. Urban formal sector wage rises will increase urban unemployment somewhat, but this may improve wage incomes in the rural formal sector, as wages are raised in that activity because of labor migration. 2/ The latter effect appears documented in Kenya by the difficulty in obtaining labor for coffee and other estate crops, and recent wage rises. The unorganized sectors are more complex. However, if what happens is a transfer from small-scale rural to informal urban because of rising wages in urban formal activity, the effect on aggregate income depends on the marginal products in the two sectors. If it is higher in rural activities, total incomes fall.

3.82 It can be seen from the discussion that this is a very complex issue, and any solution requires a precise model, which takes into account the distribution of ownership of assets as well as the functioning of the labor market. However, it does show that if, generally, elasticities of demand for labor are low, rising urban formal sector wages may increase aggregate labor incomes, as well as the consumption standards of rural smallholders. The standard of living of urban informal sector workers may go down through falling prices of informal sector services as supply increases.

1/ Harris and Todaro have usually assumed a closed economy, while Wasow, in his paper, assumed an open economy. For Kenya the open economy assumption seems appropriate, and it has the great advantage that rural-urban terms of trade effect can be ignored (i.e., trade policy and world prices are taken as parameters). Thus, rural-urban commodity price relatives are given, and only factor prices can vary. Contrary to standard theorems in trade theory, factor price relatives can vary, even though commodity prices do not, because of unemployment.

2/ The necessary condition for an increase in formal rural aggregate wages is an elasticity of demand for labor of less than unity.

3.83 It is probable, therefore, that the wage gap has important effects on the labor market. Since it is likely that the gap will grow, the problem will become progressively more severe. (The fast growth of population combined with wage increases in the formal sector related to industrial productivity will guarantee such a rising gap.) It is almost impossible to determine the effect on income distribution. It may go either way. The effect on aggregate output is certain — it reduces it.

The Urban Informal Sector

3.84 The urban formal sector has an important, and largely negative, effect on the informal sector. So important is this, that it should be mentioned, in spite of the lengthy discussions in the ILO/UNDP Report. The most important effects are two: the imposition of controls, and the pressure of labor inflow. Many of the controls, restrictions, and harassments inflicted upon the informal sector arise from a government orientation towards formal activity, itself determined by developed country standards and attitudes. It is very obvious that senior members of organizations such as the Federation of Kenya Employers do not regard the informal sector as providing anything more than make-work activity of a low standard. Several formal sector employers resent — understandably enough — the ability of the informal sector ('bamboo garages', for instance) to evade labor legislation and wage council regulations. They do what they can to prevent it. Moreover, it is very often the newly-established African businessmen in the formal sector who feel most threatened by the activities of the informal sector, and who frequently have the political power to step up the level of harassment.

3.85 A second important effect, alluded to above, is on labor supply. As the ILO/UNDP Report states, far more people come to towns looking for jobs in the formal sector than can be absorbed by the jobs available. Although many fail in their primary aim of finding formal sector wage employment, they can participate in informal sector activity fairly easily. The effect of this constant pressure on the informal sector is to increase competition and drive down returns. In this way, the gap between formal sector wages and incomes in the informal sector increases, the increasing gap continually drives down returns to informal activity, and the informal sector will probably never "take off" as long as this pressure continues.

Entrepreneurial Development

3.86 This is, undoubtedly, a most important theme, but, as with so much in development, unquantifiable. Two factors need to be stressed. In Kenya returns to paid employment in private formal industry far exceed those from all but the most profitable forms of self-employment. Indeed, businessmen are clearly not as prestigious as higher-level employees in private industry or in the public service. Second, the greater part of private activity is run or owned by foreigners, most of whom are basically imitating the techniques learned in their home countries.

3.87 In Kenya there is at present little African entrepreneurship. The importance of its development cannot be overstated. Nevertheless, all the highest perceived rewards go to employment in a sector which is largely foreign-owned and which is not itself innovating very much. Nor need it do so, given that profits are often guaranteed by tariff protection and controls. In the long run this aspect of formal sector activity may be the most costly. It preempts many of the most capable men, but is not itself providing any major entrepreneurial dynamic, probably with the major exception of tourism.

Credit Preemption

3.88 Finally, the role of the formal sector, as a whole, in preempting cheap credit mobilized through the banking system should be considered. The most serious effect is to draw financial savings from the rural areas and thus deprive the agricultural sector of one of the necessary conditions for accelerated growth. The point is not that there is an unsatisfied effective demand for credit in agriculture: rather, the reverse is true. But as long as the financial intermediaries can make easy loans to large, creditworthy clients in the towns, they have no incentive to tackle the much harder job of getting credit to the small-scale farms. In the urban areas, too, there is some evidence that small-scale industry uses capital more efficiently than do large firms -- certainly it seems to generate more employment. This may also be true of informal activity in the towns, which does not even appear in the statistics.

3.89 Annex 2 has discussed the need for a more active and flexible interest rate policy, and concludes that generally higher interest rates might be expected to stimulate savings as well as lead to the more effective utilization of scarce financial savings. Given a restricted domestic supply of funds, it is certainly peculiar to continue an arrangement whereby those firms which can borrow abroad have every incentive not to do so; while, for those firms which must borrow domestically, banks have no incentive to lend.

Conclusion

3.90 In the previous sections, the effects of the price environment of the formal sector on the economy has been discussed. It appears that trade, wage, and interest rate policy have not only much reduced the efficiency of operation of the formal sector itself, but have created spill-over effects onto agriculture, the labor market, the credit market, the informal sector, and the development of entrepreneurship. These effects may not have worsened income distribution in a static sense, although this is overwhelmingly likely, given the taxation of agriculture, but they have certainly impeded efficient growth. 1/

1/ For reasons outlined above, and further considered below, it does not seem probable to us that capital intensive development leads to higher savings rates and, consequently, growth, in Kenya. Firstly, the share of profits does not seem to be simply related to capital intensity, and, secondly, the large foreign ownership of formal sector firms means that much of the profit is expatriated.

Moreover, much social frustration is generated by the offer of glittering prizes through education, which are then snatched away. The key to more efficient and, in the long run, more equitable growth is reform in these policies. Although many issues will remain, at least some consistency and efficiency in sectoral allocation will be encouraged, as well as a reduction in the conflict between the formal sector elite and the rest.

D. THE NEED FOR POLICY CHANGE

3.91 In the sections that follow, the concern is simply with how to get the most out of the formal sector, while at the same time, minimizing its external costs. Because some such costs will almost certainly remain, the issue of how much formal sector to have, even in the best circumstances, will be addressed subsequently.

Trade Policy and the Exchange Rate

3.92 The basic proposals for reform of the trade policy environment are by now 'stale, flat, but, we hope, profitable'. Because of the staleness, this discussion will focus on the consequences of a move towards tariff uniformity and on alternative ways to get there. The areas to be considered are wage policy, the taxation of the service sectors, problems of transition and infant industries, and the effects on income distribution and government revenue. Apart from these indirect consequences, the effects on imports and exports themselves will be briefly touched upon.

3.93 Uniform Tariffs. The lengthy discussion above of trade policy and its effects leads logically to a proposal of greater uniformity of tariffs and some means of assisting exports. Such a reform would reduce the variance of effective protective rates, reduce the taxation on the production of capital goods, intermediates, and exports, increase the incentive to use domestic materials, reduce the incentive to capital intensity, increase tax revenues, and, generally, achieve all sorts of wonderful results, as promised by economists in many books and articles in the past few years. 1/ In spite of the fact that the results promised do seem a little too wonderful to be true, and, indeed, that the precise effects cannot be predicted, evidence from

1/ The locus classicus is I.M.D. Little, T. Scitovsky, M. FG. Scott, op. cit., passim.

other countries does indicate that such a reform could be very productive. 1/

3.94 It should be remembered that any level of uniform tariffs and subsidies combined with an equilibrium exchange rate has identical economic effects to any other set of uniform tariffs and subsidies combined with an equilibrium exchange rate. The differences only arise for administrative costs, and for any payments or receipts which do not involve tariffs or subsidies. Capital outflows, or service payments abroad, if untaxed, will be cheaper under a uniform tariff and subsidy system than under free trade, because foreign exchange will be cheaper, and vice versa for inflows and receipts. It is, however, possible to devise a system of taxes and subsidies on these transactions which will make the system identical to free trade. However, administrative costs will inevitably be higher if tariffs and subsidies are used.

3.95 A second important point to remember is that the effect of the trade policy reform is twofold. The major aim is to make the domestic relative prices for producers the same as international relative product prices. 2/ This is the reason for tariff and subsidy uniformity. (It may, subsequently, be possible to choose -- with care and discretion -- exceptions to the rule, for infant-industry reasons.) A second aim is to achieve equilibrium in the balance of payments. This can be done by adjusting the exchange rate or by raising or lowering the uniform tariff and subsidy system. 3/

1/ This has been accepted by the Government. In his Budget Speech of June, 1973, the Minister of Finance stated: "I am drawn to the conclusion that our long-term objectives would be reached more easily with a more even tariff structure than we have at the present time". He also stated "... our tariffs should not encourage the excessive use of imported raw materials and capital goods: the system should not discriminate against production to export; it should not discourage the use of labor." The Minister also emphasized that, in any case, the Kenyan situation requires a major change, if the manufacturing sector is not to stagnate. Thus, the alternative is not simply more of the same, as most of the easy import substitution opportunities have been already taken up.

2/ In this discussion, given world prices for all traded goods are assumed. The alternative -- that Kenya affects world prices -- can almost certainly be ignored except for a few crops.

3/ Since relative domestic prices of traded goods are given by world prices and the tariff structure, exchange rate adjustments only affect relative prices between tradeables and non-tradeables. Moreover, accepting the notion of decomposition of non-tradeables, this amounts to alteration of the relative price of labor where its price is not fixed by a demand-supply equilibrium in foreign exchange (e.g., in the formal urban sector) and all other goods. This shift can be produced by lowering of nominal wages or by raising the exchange rate or the entire tariff-subsidy system. Thus, tariff reform and exchange rate adjustment are complementary, not substitutive. This point is developed in Wasow, op. cit. A devaluation lowers the real wage of labor if the wage is fixed in nominal terms. If the wage is equilibrated to demand and supply in foreign exchange (as in small-holder tea) a devaluation, as such, will not affect the real wage at all, since the marginal product in tea remains the same. If there were no labor market disequilibrium, a devaluation could only be used as a deflationary device, through cash hoarding.

3.96 Given the above, two considerations determine the structure to be chosen in Kenya. The first is that the higher the tariff-subsidy structure, the greater the costs (in both administration and skilled manpower) of preventing evasion and fraud, and the greater the distortion between those goods which are taxed or subsidized and those, such as services or capital flows, which are not. The second, and countervailing consideration, is that the lower the structure chosen, the more probable -- indeed certain -- it is that a devaluation will eventually be required. If, for political reasons, this is ruled out, a lower bound to a tariff-subsidy structure is uniquely determined, given a goal of balance of payments equilibrium.

3.97 It is not possible here to determine the desirable ultimate structure, except that it should be more nearly uniform. 1/ Given existing tariff levels, movements towards a uniform 20 percent tariff would probably be compatible with equilibrium given the current exchange rate. Indeed, since this entails raising average tariffs for intermediates, capital goods and government imports, which account for 80 percent of total imports, the Kenya pound might then become undervalued in relation to other currencies.

3.98 Export Subsidies. As long as export subsidies are less than tariffs, exports will remain taxed. There are three arguments which might be used to justify such a relationship. The first is that, unless export subsidies are lower than tariffs or limited in scope, the tariff system will generate no revenue. If net revenue is desired, export subsidy rates must be lower than the tariff 2/ either by setting them at a lower level or limiting them to selected commodities. The second reason might be a desire to impose a general tax on exports because the Government wishes to discourage excessive reliance on them. The third argument, which is for limiting the scope of subsidies, is that some goods face inelastic demand, supply constraints, or both. These goods, such as coffee, tea, and possibly pyrethrum, might therefore not be subsidized. Taken together, these arguments justify a level of export subsidy lower than the uniform tariff and a scope limited to commodities with highly elastic supply and demand. In Kenya, this would imply a uniform subsidy of perhaps 10 percent on manufactured exports. 3/

3.99 If the administrative cost argument outlined above is considered very important, the whole system could be simplified by abolishing the export subsidy, lowering the uniform tariff to nine percent, imposing a nine percent export tax on the items to be exempted from the subsidy and allowing a corresponding devaluation.

1/ The Government has taken tentative steps in the direction of uniformity, by reducing the level of duty on some items to 40 percent from previously higher levels, and imposing duty on almost all Government imports.

2/ This assumes balance of trade equilibrium. Kenya runs balance of trade deficits, so there will remain revenue, even with a uniform tariff and subsidy.

3/ The Government has announced as a major step towards this aim a 10 percent subsidy on a range of exports valued at approximately £25 million per annum. At the same time the export tax on coffee and sisal has been abolished.

3.100 Sales and Value Added Taxes. Since Kenya still wishes to discourage consumption of luxuries and has already determined on a sales tax, these elements should be included in the scheme. As J.H. Power 1/ has shown, a value added tax is a superb basis for a uniform tariff and subsidy system, 2/ in addition to collecting plenty of revenue. A sales tax is a good second best. (It is second best because it encourages vertical integration and would, therefore, discourage sub-contracting. This aspect is minimized in Kenya, since small firms are exempt.)

3.101 A sales tax device can be used to penalize consumption of luxuries without providing incentives to their production as import duties do. It can also be used to generate more nearly uniform protection if the tariff structure cannot be changed because of EAC disagreement. 3/ A system of sales and production taxes and subsidies can be devised which will have exactly the same effect as a uniform tariff and export subsidy. Thus, Kenya can achieve its aims without a tariff reform. However, such a system would have to be very complex since effective protection for the producer depends on the price he receives for his goods net of tax, while the effect of protection on the user depends on its price after tax. In general, introduction of a sales tax will lower effective protective rates. The reason is that producers' prices net of tax are unchanged, but the cost to the user after tax is raised. 4/

1/ J.H. Power, The Role of Protection in Industrialization Policy with particular reference to Kenya, "East African Economic Review", June 1972.

2/ Some taxation of exports can be provided by raising the tariff above the VAT rate.

3/ As the main report has explained, our basic analysis is not concerned with the implications for policy of Kenya's membership of the EAC. Of course, any change in trade policy, especially any change in the common external tariff, would require the agreement of all three partner states.

4/ The e.r.p. formula becomes:

$$g_j = \frac{t_j - a_{ij} (t_i + C_i (1 + t_i))}{1 - a_{ij}}$$

where g_j = rate of effective protection on j

t_j = tariff rate on j

a_{ij} = input coefficient of i into j

t_i = tariff rate on i

C_i = sales tax on i

Thus, the effective rate of tax for exports and other low duty items will be higher as a result of Kenya's reform. The export subsidy becomes still more important. Since agricultural inputs, such as fertilizer are exempt, and farm gate prices of agricultural crops sold domestically will not be affected, agriculture will be relatively favored by the sales tax reform. On the other hand, prices of manufactured consumer goods will rise.

3.102 Problems of Transition. There are several aspects of the problem of transition to a uniform tariff and subsidy system. First of all, the change will entail major alterations in relative prices and profitabilities. Second, some industries will become unprofitable, and, finally, a squeeze on manufacturing factor incomes as a whole, including wages, will develop since the sector is on balance highly protected. It goes without saying that these aspects of reform will create major problems.

3.103 To cope with the changes in relative prices and profitabilities, it will be necessary to announce the changes in tariffs in advance, and introduce them very slowly -- perhaps over a period of five years. This now seems to be the Government's intention. Thus, in the first phase of reform perhaps only a five percent duty on zero duty items might be imposed, and so forth. If it is decided to fix the level of tariffs and subsidies at about 20 percent and 10 percent respectively, this would have the advantage, in Kenyan circumstances, of raising the relative price of tradeables on balance, and, thus, diminishing the likelihood of a devaluation during the process.

3.104 The problem of inefficient industries would be more difficult to handle. Most of them will be profitable at world prices on a current basis, although unable to amortize their capital costs. Thus, they could be allowed to continue until machinery is worn out or unprofitable on a current basis. Perhaps the best procedure is, after identifying these industries, to provide the protection required for profitability, while refusing permission to make further investment. Alternatively, a precise terminus ad quem can be given for the protection, as with infant industries.

3.105 The most difficult problem of all is wages. If the newly unprotected manufacturing sector is not to be taxed by high wages, these must be reduced in real terms. This will be done if the prices of tradeables in general are raised by devaluation, or by raising the tariff-subsidy structure. At the same time, a profit squeeze should lead to much greater resistance to further wage claims. Although there is evidence that government and employers are sufficiently strong to win such a battle, it would undoubtedly create enormous difficulties. For this reason, above all, any transition to a less protected manufacturing sector must be done over a considerable period of time.

3.106 Government Revenue. A uniform tariff, export subsidy and sales tax can considerably expand government revenues. Precise estimates require a precise scheme, but, as long as subsidy rates are lower than tariffs, and/or the scope is limited to a few goods, net revenue will be positive. Under most schemes, net revenue will be higher than at present, even leaving aside the effect of sales tax.

3.107 Policy Reform and Agriculture. The sort of reform discussed above will continue to entail taxation of agriculture. Since major crops will be exempt from export subsidies, while tariffs on manufactured goods will level at 20 percent, the terms of trade will remain against agriculturalists. This

effect can be reduced if the government permits a rise in domestic prices of commodities sold at below f.o.b. prices, such as meat, and, at the moment, maize. Since several crops, though in theory tradeable, are, in fact, largely sold domestically at officially-determined prices, it is open to the authorities to adjust them. A simple procedure would be to provide a price rise of 20 percent, or the export subsidy, which would have the same effect. In this way, all crops except tea, coffee, and pyrethrum would be benefited, and the urban real wage would be further squeezed, as desired.

3.108 Policy Reform and Non-Commodity Transactions. Since Kenya has important service transactions and capital inflows, the effects of a policy change upon them should be taken into account. As stated above, if the decision is for a tariff-subsidy arrangement, rather than for flexible exchange rates, the exchange rate will be 'overvalued'. The effect is to tax service receipts and capital inflows and to lower the costs of service payments. There is no general reason why desirable levels of taxation of the two types of payment should be the same, since the taxation should be determined by the individual elasticities of supply of foreign exchange. For Kenya the most important type of service receipt is tourism, whose elasticity of demand is apparently completely unknown. Because of this ignorance, a uniform tax on all non-commodity transactions may be the simplest compromise.

3.109 Infant Industries. A uniform tariff and subsidy system can permit some exceptions for infant industries. Such industries must be limited in number, since the more that are protected, the smaller the protection of each. If every industry gets 'exceptional' protection, none does. Second, infant industry protection should be limited in time. It can be stated in advance, as with industries being phased out during the transitional period, that an extra 20 percent tariff will be provided for five years and then will be reduced progressively. In this way, Kenya can avoid nourishing 'infants' who never grow up.

3.110 Determination of infant industry protection would become the main responsibility of the Protection Committee. All applications will have to be scrutinized very carefully from an economic point of view, to ensure that they are likely to be viable when protection is reduced, otherwise pressures for permanent exceptions may become irresistible.

3.111 Investment. Reform on the lines discussed above, and now proposed by the Government, will reduce the incentive to invest in several industries, while increasing it in others. It is not necessarily going to reduce it overall, although the composition will be changed in a more efficient direction.

3.112 Conclusion. A precise scheme on the lines discussed above could have an extremely important effect. Above all, it is a way out of the important substitution blind alley. Exporting will provide potential for

rapid further growth of manufacturing, 1/ it will provide the sort of pressure of competition that is necessary to improve efficiency, and it will make it easier to resist wage pressure, since competitiveness must be retained. Kenya, at present, has really little choice if the well-documented effects of further import substitution, export taxation, and consequent exchange crises are to be avoided. Exports will grow only if incentives are given, and not because of any amount of moral suasion. The Government has become aware of this and has announced its desire to move towards greater tariff uniformity, to implement an export subsidy and to take greater care in appraising projects. These moves are appropriate and sensible.

Wage Policy

3.113 We have described the adverse impact of a growing rural-urban income gap, particularly, on income distribution, migration, unemployment and the demand for education. The reformed policy package outlined above would go a long way to alleviating these adverse effects. Reduction of protection to manufacturing and increased exports in competitive markets would certainly give a substantial incentive for employers to resist wage increases. Failing an incomes policy, increased competition is probably the best way to restrain firms' willingness to grant wage increases, and also employees' desire for them, since as argued before, high and secure profits allow firms to be generous and encourage employees to be greedy. At the same time, the devaluation or raising of the general tariff-subsidy level, combined with corresponding rises in the prices of domestically consumed agricultural commodities, will reduce the real wages of those whose incomes are fixed in nominal terms. The result will be to lower the rural-urban real wage gap, increase equilibrium wages in the urban informal sector because of reduced migration, and increase real incomes of small holders because of improved terms of trade. 2/ (Wages in the formal rural sector may fall, however, because of reduced migration.) Thus, the trade policy package fits naturally with the aim of formal sector wage control.

3.114 For such a strategy to work, it is essential that Government can "win" in any confrontation with labor unions. If nominal wages in the formal sector are forced up again, and minimum wages are raised as well, little will have been gained, even after a devaluation. For this reason the adjustment

1/ The greatest advantage is that demand elasticities being very high, exports of manufactures are, if competitive, only limited by supply constraints, and full advantage can be taken of economies of scale. This is very rarely so for import substituting firms in small markets. Moreover, import substitution in Kenya has, as might be expected, required the creation of many inefficient monopolies or tight oligopolies. The market is too small to support many firms in most industries. These competitive-efficiency arguments are important. See J.N. Bhagwati and A. O. Krueger, Exchange Control, Liberalization, and Economic Development, Papers and Proceedings of the Eighty-Fifty Annual Meeting of the American Economic Association, American Economic Review, May 1973, pp. 420-422.

2/ The real incomes of small-holders may conceivably fall if returned migrants have marginal products below consumption, but this is very unlikely given the assumed terms of trade improvement.

must be slow. It should be stressed, however, that there are cases in which employers have won such battles. In Kenya, unions only represent 40 percent of the total number of wage earners in the formal sector, and 25 percent of all wage earners, so their power is limited.

3.115 One important precondition of success is that productivity increases are not accepted as an argument for wage increases. This would mean, inevitably, that the wage gap will grow with consequences in terms of increased unemployment, which have already been described. In a dual economy, productivity related wage increases in the modern sector mean that benefits which might accrue in the form of faster growth ^{1/} or lower prices, in fact go to labor. Since growth is a central aim in itself, this use of productivity changes is disadvantageous. It is even more so if it increases inequalities and labor market disequilibrium.

3.116 In the basic strategy underlying this report, however, we are concerned less with wage policy as such as with measures to increase the incomes of Kenya's poor. Thus much of the analysis and argument is concerned with reorienting growth towards increasing agricultural production as the major means of increasing incomes for the mass of the labor force. We see the agricultural sector as the residual employer, and rural incomes as a function mainly of agricultural productivity. A very real danger which threatens agriculture's capacity to provide employment is the possible extension of minimum wage standards to the small farm sectors. Such a move would create for the rural areas the same kind of open unemployment (but on a much larger scale) as the determination of high wages for the formal sector has in the urban areas. Trade unions have traditionally been more concerned about securing more benefits for the existing members (who are already among the privileged few in the formal sector employment) than about increasing membership by increasing employment. ^{2/} The extension of this approach to the informal sector would be disastrous to future employment in Kenya.

Interest Rate Policy

3.117 It is appropriate, also, to review interest rate policy. The arguments outlined above are basically for much greater flexibility. This will be the major recommendation. In addition, it should be questioned whether it is desirable to permit foreign firms to borrow money more cheaply in Nairobi than in London or New York.

^{1/} Essentially, permission to workers to benefit from productivity increases in dynamic industries reduces their profitability, which is the major growth signal, and, at the same time, increases the disequilibrium in labor supply.

^{2/} The participation of the unions in the series of Tripartite Agreements, where they agreed to suspend wage claims in return for an increase in employment, was a hopeful exception to their normal behavior.

Some Major Consequences of Policy Reform

3.118 Although the policy reform discussed above will improve the performance of the formal urban sector, and reduce its costs to the rest of the economy, there may still remain conflicts of goals. For instance, although large-scale enterprises are likely to do best in exporting and will, through continued access to cheap capital, have an advantage, small-scale ventures may generate more employment, because of lower capital-labor ratios, and may also be superior means of developing African entrepreneurship. The authorities may wish to penalize large-scale formal activity for this reason, or because of a desire to reduce dependence on foreign skills and entrepreneurship. Alternatively, special favors to small-scale industry may be considered.

3.119 Perhaps the most important areas is that of income distribution which has been only touched upon at various points. If the sole change is in urban formal sector real wages, it can be shown that profit earners in the economy will almost certainly increase their aggregate incomes. Urban informal sector incomes per head will probably rise while individual wages in rural formal employment will fall because of reduced migration, and average consumption in small-holding will also fall, if there are decreasing returns to labor. However, total labor and small-holder incomes could still rise, depending on the relevant elasticities, since GDP will rise with employment. If a real wage change goes along with a change in trade policy, it is much more likely that rural real wages and small-holders real incomes would rise, and that profits in urban activities would fall. It would be possible to work out a precise model but, at present, the parameters are unknown. However, it is clear that improvements in real incomes per head of all but urban formal sector workers, and improvements in aggregate labor and small-holders incomes are very likely, if the full reform discussed above is put into effect. There can be no question, however, that a successful reform will reduce real incomes per head of those in urban formal sector employment, in the short run. Such an effect would seem to be in accord with the Government's stated objective of distributing the benefit of development more equitably.

E. CONCLUSION

3.120 In this lengthy argument, an attempt has been made to show that the price environment of the formal -- especially urban -- sector, reduces its efficiency and imposes considerable, and growing, costs on the rest of the economy. It is also argued that a major overhaul of trade policy along the lines the Government is itself proposing is the foremost requirement for improvement. The steps taken by the Government so far are only the first, but they are an earnest of good intentions and deserve the fullest possible

support. A reform should, if carefully introduced, also substantially reduce the problems created by a distorted wage structure, although it cannot hope to remove them entirely. Finally, it is argued that a policy reform which includes a reduction in protection to import substituting manufacturing, and a reduction in urban formal sector real wages is likely, in conjunction, to improve income distribution, by raising real incomes of those the ILO calls the "working poor". Reductions in real incomes of the middle-class of formal sector employees will have to be set against this. However, it should be remembered that, if the improvement in efficiency and growth is considerable, all the population can be made better off in the medium-to-long-run.

CHAPTER 4. CONTROLS ON TRADE AND FOREIGN EXCHANGE

A. INTRODUCTION

4.01 This chapter is an examination of the effect of controls on current balance of payments transactions on the private sector. It excludes from its scope controls on internal prices, which are a pervasive feature of the Kenyan economy, and also controls on capital flows. ^{1/} However, certain of the controls and measures of supervision, which affect current transactions, are, in fact, aimed towards control of capital flows. As a result, the discussion will have to touch upon that area as well.

4.02 The reason for this narrow focus is simple. The annex concentrates on the effect of the private sector's environment on its operation, and price control and controls on trade affect that operation more than any other controls. However, almost nothing is known about the effects of price controls so we shall concentrate on the controls on trade. Moreover, this focus fits in perfectly with the previous emphasis on trade policy in Chapter 3.

B. PROTECTION AND THE CONSERVATION OF FOREIGN EXCHANGE

4.03 The issue discussed here is the use of controls for protective reasons. In Kenya the growth of such controls has been rapid, and they have now made tariffs largely redundant as protective measures. The details of the system will be discussed below, and the effects can be understood in terms of the discussion in Chapter 3. A repetition of the discussion will be largely avoided, since the controls have exacerbated the effects of the tariff system, and have not worked against it to any great extent.

History of Protective Controls

4.04 "Prior to 1972 the importation of goods into Kenya was regulated solely according to the objectives of the licensing policy of the government as administered by the Department of Trade and Supplies." ^{2/} The legal foundations of the present system had been laid by the Imports, Exports, and Essential Supplies Act of 1962. ^{3/} This established the Department of Trade and Supplies to supervise the system. Under the legislation, items entered Kenya under Open General License (O.G.L.) or required a Specific Import License (S.I.L.). The scope of such specific import licenses could be determined by the Minister of Commerce and Industry.

^{1/} This issue will be touched upon subsequently in Chapter 5, Foreign Private Investment.

^{2/} V. Vinnai, The System of Exchange Control in Kenya, Discussion Paper No. 148, IDS, Nairobi, September 1972, p. 3.

^{3/} The source for most of this is D.S. McRae, Import Licensing in Kenya, op. cit.

4.05 From 1964, the year of independence, until 1972, commodities were organized into three schedules. "Items appearing under the first schedule were only to be imported from places other than Uganda and Tanzania under and in accordance with an import license. Those appearing under the second schedule required a license wherever they originated. Those under the third schedule required licenses if imported from Tanzania and Uganda otherwise than by or to the order of the Kenya National Trading Corporation." 1/ 2/ In 1964 the first substantial increase in items under S.I.L. occurred.

4.06 The second substantial increase occurred in November, 1968. As can be seen in Table 29, at least 37 percent of the value of net home consumption 3/ was affected by S.I.L.s in that year. This is a jump of about 13 percent over 1967. Subsequently, the proportion fell, partly because of the effect of the controls themselves, and dropped to about 19 percent by 1971.

4.07 Over the entire period the most striking feature is the growth in the number of licensed items in SITC categories 6 (manufactured goods classified chiefly by material), and 8 (miscellaneous manufactured articles). In 1964 there were only 19 items at the six digit level in the two categories under license, but by 1972 there were 130 items, which was over 40 percent of the 317 items in these categories produced in Kenya. 4/ Thus, import licensing has become, within a short period, a pervasive fact in the manufacturing sector. For the economy as a whole the number of items under S.I.L. increased from 69 in 1964 to 228 by 1972, when the total number of items produced was 688. 5/6/

4.08 The main purpose of the system has been to protect local industries. Because this form of protection is, unlike the tariff, at the disposal of the Kenyan authorities, it has been used with increasing frequency. For instance, out of fourteen applications for protection made to the Industrial Protection Committee in 1972, six included requests for import restrictions, and five were granted.

4.09 A subsidiary purpose of the licensing system is to assist Kenyanization of wholesale trade. This is done by restricting items to K.N.T.C. (at present 48), which permits trade only by their agents, who are African.

4.10 Applications for protection are sent to the Director of Industry at the MCI, and his department carries out the initial investigation. Applications are then referred to the Industrial Protection Committee, which includes

1/ KNTC has had a large number of items confined to it. The purpose of this is the Kenyanization of wholesale trade.

2/ D. S. McRae, op. cit., p. 3.

3/ Net home consumption = total value of commercial goods entered at time of importation for consumption + commercial goods ex-warehoused for consumption in Kenya - goods transferred from Kenya to Partner States + goods transferred from Partner States to Kenya - goods reexported under drawback.

4/ See Index to Manufacturers and Products, Ministry of Commerce and Industry, Nairobi, Kenya, 1972.

5/ Ibid.

6/ Items on the S.I.L. list have been very rarely removed, so the net increase of 159 is virtually the gross increase too.

representatives of the Ministries of Commerce and Industry, Finance and Planning, and Agriculture, as well as advisors. This committee decides on the exact nature of the protection to be granted, which is usually import restriction or duty drawbacks on imported inputs, or both. The Director of Trade and Supplies executes the instructions as far as import licenses are concerned, through his import licensing officers.

4.11 Import licenses restrict the freedom to import in five basic ways: price range restrictions, quantitative restrictions, approval by specific bodies, one-channel importing through the K.N.T.C. and total bans. The first method is commonly used for manufactured items, such as soaps or bicycle tires, where imports are permitted only if above a certain unit price; quantitative restrictions are straight forward enough in concept, and are, in fact, frequently superimposed upon price range restrictions; the third method is used for imports of items like millet, which must be approved by the Ministry of Agriculture, or paints, which require approval of the Association of Manufacturers; in 1971, 9 percent of total net imports were directed through the K.N.T.C., whose concentration is in foodstuffs, where it handled 43 percent of imports; total bans are issued for many foodstuffs and also for items characteristically produced by the Kenya Industrial Estates.

4.12 Because of the foreign exchange crisis of late 1971, an entirely new element entered the picture. This was the use of import controls as a means of conserving foreign exchange. Although protection of local import substituting industry has as part of its purpose the saving of foreign exchange, this is by no means the main aim, which is to assist rapid industrialization. Thus, the developments of 1972 were genuinely new in spirit, since they were directed entirely to the aim of saving foreign exchange.

4.13 The Central Bank Circular E.C.1. of January 1972 detailed the new regulations intended to deal with the crisis. Restrictions were considerably tightened on items already under S.I.L., and were placed for the first time on many items under O.G.L.. Five schedules were drawn up, of which A, B, and C included all items already under S.I.L., and D and E items which were previously under O.G.L. Schedule B and E items were banned; schedule C items could only be authorized by commercial banks when specific prior exchange control approval had been granted; the banks could authorize payment for items in schedule A subject to the provisions of administrative notices and instructions; and schedule D items would require a 'no objection to foreign exchange' certificate from the Director of Trade and Supplies.

4.14 Essentially, the aim of the circular was to ban or restrict all 'unnecessary' imports, which were considered to fall into two categories. The first, which included almost all the items under S.I.L. and several under O.G.L., consisted of goods produced in Kenya. The second category was luxury goods previously imported under O.G.L., and now placed in schedule D. This desire to exclude all unnecessary imports - thus defined - made it necessary to add the two new schedules of previously O.G.L. items and to make the regulations affecting S.I.L. items substantially more restrictive.

4.15 One hundred and twenty seven items in Schedule B were banned, but this was no great change, since most had already been excluded. However, the 23 banned items in schedule E had previously been under O.G.L., so this was a major new restriction. Schedule C items, which numbered one hundred and twenty, were all put under quota. The quotas were allocated to importers on the basis of past performance, and initially ran at 50 percent of 1970-71 levels. Schedule D items, numbering 46 were also put under quota on the same lines as for Schedule C. Finally, the treatment of the 52 Schedule A items was unchanged from the prior position.

4.16 As a result of this new system, 369 items, including 70 previously under O.G.L., were placed under some restriction. One hundred and fifty were banned entirely, and a further 167 were put under quota. It has been estimated that 38 percent of 1971 net home consumption was affected by the circular. ^{1/} Particular areas of concentration were Beverages and Tobacco (where the proportion was 98%), Food and Live Animals (69%), Miscellaneous Manufactured Articles (51%), and Manufactured Goods Classified Chiefly by Material (46%). The introduction of this system clearly marked a major change in both the extent and intensity of import restriction and control.

4.17 The Government intended to save £ 25 million in foreign exchange, and believes that it has succeeded. However, although imports have clearly fallen, it is very difficult to tell whether the restrictions were responsible, since the late 1971 import boom seems to have been in part the result of stock-piling, exceptional investment, and unique phenomena like the drought. An analysis of the 1972 trade figures in relations to the restrictions has not yet been undertaken.

4.18 It is clear that the extent of import restriction grew very considerably after 1964, and that a complex system of regulation, mainly for protective purposes, already existed by late 1971. Faced with an apparent crisis in the balance of payments in 1971, the authorities reacted by introducing extensive exchange control. Many O.G.L. items were banned or put under quota, and restrictions on items under S.I.L. were tightened. The system had two overlapping purposes, and a consequence that not only items already produced were protected, but also many luxuries not yet under production. It did not taken long for the effects of the latter incentive to become apparent.

4.19 In the middle of 1973, because of the improving foreign exchange position, and the problems that the controls had created, the Government substantially reformed the system. Schedules A to E became Schedules I to IV. The O.G.L. items, with the exception of motor cars, were all derestricted.

^{1/} D. S. McRae, op cit, Appendix C. Table II. This table shows what would be the affected percentage of net home consumption if the schedules were applied to 1971 values. See Table 30.

The number of banned items under S.I.L. fell from 127 to 83, and items under quota remained at about 120. Thus, the number for which the foreign exchange would be granted automatically rose from 52 to 131. Although the number of items subject to S.I.L. continued to rise (by about 12%), the impact of the system was substantially reduced, since the number of items under foreign exchange restriction fell from 316 to 205. Nevertheless, the system remains much more restrictive than prior to January 1972, since, for 205 items, foreign exchange control continues to be superimposed on the basic S.I.L. system.

Consequence of Protective Controls

4.20 The general line of policy discussed above, and its recent developments, have consequences which have been extensively discussed in the literature. Previous work in Kenya, and the Mission's own investigations, only provide indicative evidence for most of them. Indeed, even thorough examination would not provide conclusive evidence on the effects. However, what is known about them can be stated, and can be weighed against the benefits. Since many of the effects parallel what has been said about trade policy above (Chapter 3), the concentration here is on aspects peculiar to quantitative restrictions.

4.21 The first point is that the system requires a considerable bureaucratic input. Until recently, there was only one licensing officer in Kenya, but the number may increase to six or seven quite soon. Because licensing is a difficult job, the requirement is for fairly skilled manpower. If the manpower is not skilled, the job will not be done well, but if the manpower is skilled, a very scarce resource is being employed. One of the administrative costs is that of policing. The restrictions do not apply to goods produced in the Community, although they do apply to any good imported through either of the other Partner States. It is necessary to establish customs posts to check items for this distinction. In general, smuggling and incorrect identification of consignments has been a constant problem.

4.22 Substantial administrative problems arise because six digit SITC categories contain many disparate items, some of which are produced in Kenya, while others are not. For a manufacturer this creates special difficulties, since he must give the authorities written confirmation from the manufacturer of the product range that the specific item in question is not produced in Kenya. The mission received specific complaints on these lines about screws, while McRae ^{1/} mentions the case of handbag fasteners.

4.23 The economic costs of quantitative and price range restrictions arise both from the original S.I.L. system, and the new exchange controls. It is useful to analyze them by the type of cost, rather than by the aim of the restriction, since the effects of the varying policies are often similar. Mention will be made of the policies which are likely to create any given effect. In discussing economic costs, the focus is on costs to the economy as a whole and not only to specific groups.

^{1/} D. S. McRae, op. cit. p. 27.

4.24 Delay is an important source of cost. Four cases can be distinguished: the first is where an article's international price oscillates considerably. An example is wire rod, where, apparently, the common delay of two to three weeks may be associated with a price fluctuation of five percent. This is a cost to the importer, but also to the economy. A second case arises if delays lead to a desire to hold larger stocks. This is now common to many firms in Kenya, who have been caught twice by the introduction of unanticipated controls -- in the beginning and end of 1972 -- and found production increasingly difficult as stocks ran down. Their present desire to secure larger stocks, which is expensive for them and the economy, 1/ and will create considerable balance of payments problems once controls are lifted. The third problem is the effect of delay on transport costs. One of the side-effects of the introduction of the General Superintendence system has been such delays in processing that the use of air-freight has become necessary. This imposes a considerable additional cost on importers and the economy. Finally, in extremis, firms have to close down as raw materials stocks have been used up. This has occurred in a few recent cases.

4.25 The S.I.L. system, its recent tightening, and the temporary restrictions on O.G.L. items, some of which were already produced in Kenya, created absolute protection for many manufacturers of consumer goods. On the basis of the mission's interviews, it would not be an exaggeration to suggest that several firms have a license to print money, being subject to no competition, either at home or abroad.

4.26 The same effect -- but with more serious consequences -- occurs with those intermediate goods which are now produced in Kenya under restriction. Important items like packaging -- which is vital to the development of agricultural processing and other industries -- are restricted, because they are produced domestically. Complaints of excessive prices are not uncommon, and such high prices imply heavy taxation of exporters. At present, several chemicals, vehicle tires, paper packaging, cement, wire rods, wood screws and many other such goods, are subject to import restrictions or bans. Although this offsets to some extent the low effective protection apparently given to intermediates by the tariff, it also implies taxation of users. Some of these taxation rates are very high. 2/

4.27 The new measures did, and, to some extent, still do create a class of privileged quota holders. This applied especially to importers of luxury consumer durables, many of which were placed in Schedule D. The effect is essentially to transfer tax revenue from Government taxes to the quota holders. In addition, the manufacture of such durables is made very attractive. A

1/ Stock accumulation for this reason is an exceptionally fruitless way of tying up capital, from a social point of view.

2/ It would be an interesting piece of research to examine the relative inflation on restricted and unrestricted items, during 1972. This has not been done, since the data are not yet available.

perfect example is the assembly of motor cars, which is not economically viable, but could, if the quota remains and the components are imported duty free without restriction, be financially very lucrative. Several interests are now pushing for this development in what is almost certainly a negative value added industry. Thus, controls on inessential imports make production very attractive, and soon the inputs required will have become, as if miraculously, totally essential.

4.28 The fact that quotas are based on importers' past performance has several important consequences. First, it is the established firms who benefit, while smaller African traders have a particularly difficult time. Second, the restrictiveness of the control depends on the rate of growth of demand. Thus, importers just opening new lines have been heavily penalized. Finally, several of the established firms are foreign owned and are, therefore, able to expatriate profits created by the restrictions. This is a straightforward transfer abroad.

4.29 The entire system benefits large and well established firms. Dealing with the bureaucracy requires time and money -- both assets of large firms. The more complex the system becomes, the more important are these assets. While several new African firms have been squeezed out both by the allocation of quotas, and the costs of dealing with the bureaucracy, others with good connections have obtained licenses for foreign firms. These so-called "brief-case" importers are an important part of the new African business class. It is not obvious this is a good test of entrepreneurial ability.

4.30 In general, the entire system creates monopoly producers, and monopoly traders. Producers are subject to little or no competition at home, and, because they export very little outside the Kenyan or E.A.C. markets, they are subject to little external competition. This has been a recipe for stagnation in many countries, and there is little reason to suppose Kenya will avoid these effects. In addition, because quantitative restrictions, unlike tariffs, impose no price ceilings, it is necessary to introduce whole new mechanisms of price control. It is not surprising that ministers have recently complained about the poor quality and high prices of absolutely protected import substitutes. 1/ It is also not surprising it has happened, since that is the direction in which incentives direct the firms. The price control solution is just one aspect of the logic of controls breeding further controls, to which we refer further below. Finally, the creation of monopolies makes it exceptionally difficult for the new entrepreneur to break in, 2/ outside the protected circle of K.N.T.C.

1/ "Product quality and manufacturing service have all too frequently been secondary considerations in the mind of the manufacturers who tend to squeal every time they are touched by competition from outside and to run to the Government to bale them out every time they run into trouble". Budget Speech, June 14, 1973.

2/ See V. Vinnai, op. cit., p. 16, "...the method used here - the application of reference periods - will close the market to newcomers, which seems contrary to another aim of import licensing, namely the Africanisation of import trade."

4.31 A very particular twist to Kenyan import licensing is the use of price-range restrictions. This system has the following effects: first, it encourages over-invoicing, since an importer has no benefit from announcing a lower price than the minimum; secondly, it encourages the import of more expensive articles, which increases the foreign exchange cost; and finally, it provides complete protection for domestic inefficiency below the specified price.

4.32 One particular problem with the use of quotas is that it loses revenue to the government. 1/ This revenue is then earned by import quota holders. In the case of the January 1972 measure, for example, the revenue loss has been estimated at about £ 7,000,000. This is quite a significant sum.

4.33 One of the major problems created by the habit of tackling foreign exchange crises with import controls is that it becomes progressively more difficult. At each stage there is less 'fat' to trim, but, since every bout of restriction tends to tax exports further, there is more need to trim 'fat'. As Vinnai states, "...exchange control at present has little flexibility should the 1971 deficit repeat itself." 2/ The recent relaxation has not restored the status quo ante. Thus, in the next drought, tourist scare, or fall in export prices, Kenya will have to cut back investment and start reducing allocations of raw materials to firms. This is why development of exports is vital, but the restrictions and delays, superimposed on the tariff system, make it unlikely.

4.34 There is, as can be seen, a logic to the development of controls -- a process which Kenya is now beginning, but which many countries have followed much further. Controls breed high profits, so price control is introduced. Controls make future management of exchange crises more difficult, and the new restrictions begin to affect the level of output. Controls produce monopoly profits for importers, so quotas are given directly to investors and producers, who must, therefore, themselves be controlled. Meanwhile, desperate attempts are made to encourage exports and new small businessmen, while every incentive in the economy goes against them.

4.35 Kenya is at the start of this process. The recent reduction in the controls is an encouraging sign that the Government is aware of the problems. However, this is only one step forward and two steps back. The decision to protect domestic production with extensive import restrictions, and the use in its first exchange crisis of import controls, may indicate its willingness to use further controls. The costs of such a process should be weighed carefully beforehand. Few countries have developed through high-cost private monopolies and extensive direct government allocation of resources. In Kenya, where skilled manpower is exceptionally scarce, such an approach

1/ A ban is like a prohibitive tariff, and both have the same revenue effect, i.e., they reduce revenue to zero.

2/ Ibid, p. 19.

seems particularly inappropriate. This early stage may also be the last at which Kenya can easily draw back. Thus, it is to be hoped that decontrol will be taken much further, especially by reducing the scope of the S.I.L. system.

Policy Alternatives

4.36 The suggestions on policy follow closely on what has been said above in Chapter 3. If possible, the use of quantitative restrictions should be reduced, and they should be replaced by tariffs (which would put a ceiling on prices, will ensure some competition, will reduce monopoly profits of quota holders, and generate tax revenue). Moreover, the tariff should move towards uniformity, with exceptions for transitional reasons, or infant industries. The transition from controls to tariffs may be more difficult than from high to low tariffs, since the tariff equivalent of the quota may be very high indeed. ^{1/} It may be necessary to put an exceptionally high tariff on during the transition phase, or, if this is impossible because of the E.A.C., to relax the controls very gradually.

4.37 Clearly, one of the aims of the 1972 regulations was to inhibit the consumption of luxury items. The desire of the Kenyan government not to sacrifice development for the consumption of Mercedes Benz cars is extremely understandable. However, it can employ a method which does not encourage the domestic assembly of such cars. The best way is a heavy tax on the consumption of such luxury goods, which would not create the protective effect of tariffs or quotas.

4.38 Assuming the authorities will not substantially alter their use of protective controls, methods can be devised to break some of the inhibiting effects of stagnant monopolies. An approach used by some governments is to provide quota protection in the domestic market in return for a given proportion of exports. If these exports are not achieved, the quota protection is reduced. At the same time, the monopoly rent obtained by quota holders in the import trade can be reduced by charging for the licenses, as, effectively, the Kenya National Trading Corporation does.

4.39 The approach suggested above makes sense in the long run, but the authorities will still be concerned with the problem of crisis management. It is the mission's view that other policy weapons can be used which will not create the distortions of the measures discussed above. Reserves can be accumulated to meet short-run fluctuations, and various ways can be found to increase the effective price of foreign exchange. A particular weapon, which has been used successfully in other countries, is an import deposit scheme. In any case, another crisis can be expected at some time in the future in any

^{1/} If the desire is for a total ban, there is no reason to replace a control by a prohibitive tariff, but it will be necessary to have a heavy consumption tax, if the protection is not to lead to domestic production, in many cases.

country so dependent on a few items (coffee, tea, tourism) for earning the bulk of its foreign exchange. Now is the time to prepare policies which will not cause the side effects of a regimen of controls.

4.40 The control system which has developed in the recent past is a potentially costly development. It appears that alternatives can be found, and that now, when the balance of payments is in a favorable position, is a good time to go as far as possible to dismantle it.

C. OVERINVOICING, TAX EVASION, AND CAPITAL FLIGHT

4.41 The Kenyan authorities have been concerned, especially in the recent past, with two related problems, namely overinvoicing and capital flight. The primary problem is capital flight. Kenya has a large non-citizen resident community, and a large citizen non-African community. Both of these groups have some reason to feel insecure. Both may wish to expatriate capital, and together they own a substantial proportion of Kenya's private assets. The mission estimates, for instance, that Asian capital may be as much as £ 300 million. The measures taken to attack this problem, however, created very serious spill-over effects onto the rest of the economy.

The Problem of Overinvoicing

4.42 Two quite dissimilar problems surface in the phenomenon of overinvoicing of imports (and underinvoicing of exports). The first is the attempt to expatriate capital by those groups who are not otherwise allowed to do so. Emigrants from Kenya must place most of their assets in a blocked account, which entails the enforced holding of approved securities for at least five years, before capital can be expatriated. ^{1/} Residents cannot expatriate capital at all. The second problem is the attempt to evade taxes on profits by companies who are allowed to expatriate dividends and capital (i.e., those who have a Certificate of Approved Enterprise). Although both these reasons for fraud lead to overinvoicing, they require different policy weapons to deal with them.

4.43 Economic analysis of this sort of overinvoicing is quite complex. ^{2/} It depends, in the first place, on whether companies are engaged in transfer

^{1/} The approved securities are in very short supply, so non-residents have little option to purchase them. The result is that moneys of residents leaving the country are effectively totally blocked. (See V. Vinnai, op. cit., p. 13.)

^{2/} A classic reference on this subject is J. Bhagwati, Fiscal Policies, the Faking of Foreign Trade Declarations, and the Balance of Payments, Bulletin of the Oxford University Institute of Economics and Statistics, February, 1967.

pricing, which permits them to declare profits in the country with the lowest tax rate, or whether they are trying to hide true flows so as to evade tax altogether. The latter requires different invoices by exporters and importers, and the consequent salting away of the difference. A transaction of this kind is presumably made much easier, if the importer and the exporter are both part of the same firm.

4.44 If the intent is to avoid all taxes by the latter method, economic analysis is rather simple. By raising the apparent price of imports, the firm saves itself corporation tax in Kenya, but pays duty on the additional value of imports. Thus, there is a level of duty at which this transaction is unprofitable. 1/ In Kenya, the corporation tax on dividends expatriated is 47.5 percent, which makes overinvoicing a more economical way of withdrawing profit when the duty rate is less than 90.5 percent. Since there are few duty rates as high as this in East Africa, there is clearly a general incentive to avoid tax through overinvoicing.

4.45 Let us turn to the case of the firm that intends to pay tax, but, through various price adjustments, wished to minimize the burden. Assume, also, a double tax agreement between the country in which the central office is situated, and Kenya. If the tax rate in Kenya is less than, or equal to, that of the host country, the firm has no incentive to withdraw profits through overinvoicing of imports. If, however, there is a higher rate in Kenya, there is such an incentive. In this case, overinvoicing saves the same tax as in the previous example, but there is additional tax burden overseas. 2/ Using the formula given below, and assuming the overseas tax rate is 40 percent, the

1/ The condition is that the duty rate should be less than the corporation tax rate over unity minus the corporation tax rate:

$$\text{Pr}' > \text{Pr} \quad \text{iff. } M\Delta P t' + M\Delta P t t' - M\Delta P t > 0$$

where

- Pr' = profit after overinvoicing
- Pr = profit without overinvoicing
- M = quantity of imports
- ΔP = change in price of imports
- t = duty rate
- t' = corporate tax rate in Kenya

The first two terms are the tax saved, which is $M\Delta P (1 + t) t'$; the last term is the tax lost, which is: $M\Delta P t$. Simplifying, the condition is $t < \frac{t'}{1 - t'}$

2/

$$\text{Pr}' > \text{Pr} \quad \text{iff. } M\Delta P t' + M\Delta P t t' - M\Delta P t - M\Delta P t'' > 0$$

where $t'' =$ foreign corporate tax rate.

Simplifying; the condition is $t < \frac{t' - t''}{1 - t'}$

critical rate of duty is 14 percent. Since tariff rates of this magnitude are common in Kenya, this sort of overinvoicing is a marginal activity. 1/

4.46 In cases like this, the general rule must be that the higher your corporate tax rate and the lower the rate of duty on imported inputs, or rate of subsidy on exports, the greater the likelihood of export underinvoicing or import overinvoicing. Correspondingly, the higher the rates of duty and subsidy, the greater the attraction of export overinvoicing and import underinvoicing. The major problem that concerns the Kenyan is import overinvoicing. It cannot be denied that duty rebates and remissions, and low tariff rates on imported inputs, provide a substantial incentive for this activity.

4.47 One additional incentive to overinvoicing might be mentioned. If an international firm establishes itself in Kenya, on condition that the Kenyan government or Kenyan citizens take a share in its equity, it can have a great incentive to overinvoice on inputs imported from affiliates overseas, or underinvoice on exports sent to them. The reason is that any losses to the local company brought about by overinvoicing are shared with the Kenyan equity holders, but the direct gains from overinvoicing accrue to the international company alone. 2/ This changes the attractiveness very dramatically. Thus, a wholly foreign-owned enterprise (with a 40% overseas corporate tax rate and a 47.5% tax rate in Kenya) would find overinvoicing attractive only if the duty were less than 14 percent, but an enterprise with 50 percent Kenyan participation would have an incentive to overinvoice any imports carrying a duty of less than 153 percent. The larger the extent of Kenyan participation, the higher the duty would have to be to discourage overinvoicing: if the Kenyan share was 80 percent of the equity capital, overinvoicing would be attractive

1/ A similar analysis can be developed for cases of over and underinvoicing of exports and underinvoicing of imports. The latter, for instance, is attractive if the tariff rate exceeds the black-market premium of foreign exchange. Overinvoicing of exports in a multinational company may occur if the firm's tax rate in its base is higher than in Kenya. Underinvoicing of exports may be analyzed in the same way as overinvoicing of imports. If tax can be evaded and export subsidies are low or non-existent, it will usually be profitable. If tax cannot be avoided (i.e., your cheap exports are someone else's cheap imports), the attractiveness of the operation depends on the difference between the tax rates in Kenya and abroad.

2/ It is easy to show that the condition for overinvoicing to be profitable is:

$$t < \frac{1 - t'' - S(1 - t')}{S(1 - t')}$$

Where S = the share in equity of the firm overinvoicing.

at duty levels of over 500 percent! Thus, Kenya's own policy of encouraging local equity participation in foreign companies is a very potent incentive to overinvoicing! This factor needs to be weighed against possible advantages of local participation in determining future policy. 1/

4.48 It appears there are substantial incentives to overinvoice imports in the present Kenyan situation. There are many low or zero-duty import items, and many foreign controlled firms with substantial Kenyan participation. These incentives to overinvoice to evade tax are clearly the result of government policy. 2/

4.49 Overinvoicing to send capital abroad is a different phenomenon. The desire is believed to be particularly strong in the Asian community. It can be analyzed very easily from an economic point of view. Such overinvoicing is profitable whenever the tariff rate is less than the black-market premium on foreign exchange. At present, the premium is about 40 percent. Thus, on any goods carrying a duty of less than 40 percent, it is cheaper to expatriate capital through overinvoicing than through the black market. For example, at the present blackmarket premium £ 1,000 would purchase only about US\$2,000. However, if overinvoicing of an item carrying a 20 percent tariff were the alternative, the same £ 1,000 could earn US\$2,240 in foreign exchange (i.e., \$2,800 less the 20% duty).

4.50 It appears that, under present conditions in Kenya, both types of overinvoicing will continue to be profitable unless tariffs are quite high. Increases in low tariffs, towards a more uniform rating structure, would certainly reduce the incentive to overinvoice somewhat. But the problems of tax evasion and capital flight will continue. For the Kenya Government, the problem is to control them, without strangling trade.

Policy Measures Adopted

4.51 It cannot be said that the authorities have approached the issue with any finesse. They simply started a major policing operation. On 1st December, 1972, E.C. 24/72 was released by the Central Bank. The circular stated that all imports into Kenya in excess on an invoice value of £ 100 were henceforth subject to foreign exchange licensing and had to be cleared by the Department of Trade and Supplies and the Central Bank. The main purpose of this was to use the General Superintendence Co. Ltd. of Switzerland to check on overinvoicing. All imports in excess of an invoice value of £ 1,000 were, in future, to be subject to preshipment quality and quantity inspection, and price comparison.

1/ The ILO/UNDP Mission cited other reasons for recommending that investment in foreign international firms is not a sensible use of Kenya's scarce capital. See ILO/UNDP Report, op. cit., p. 191.

2/ ILO/UNDP Report, op. cit., p. 455, estimates that if the average overpricing ratio for all intermediates were 5%, the total outflow of resources due to transfer pricing would have been 2.9 times as great as actually repatriated profits in 1968.

4.52 "Foreign exchange allocation licenses issued by the Central Bank of Kenya, Exchange Control are required for all imports except for certain specified exceptions. Importers were required to apply for foreign exchange allocation licenses before placing firm orders. Sellers were requested to give at least ten days notice before shipment to the Inspection Agency indicating the place where the goods could be inspected and the expected time of shipment. After completion of the inspection, the Inspection Agency would issue a report of findings, which would either be a clear report of the findings, if the inspection yielded a satisfactory result, or a non-negotiable report of findings if the inspection revealed discrepancies." 1/

4.53 At the same time the five schedules discussed above were kept unchanged, although Schedule A items were to be given foreign exchange automatically. All O.G.L. items, excluding those in Schedules D and E were also to be given foreign exchange automatically.

4.54 A major part of this system had nothing to do with overinvoicing. That is the fact that almost all imports had to pass through the Department of Trade and Supplies. The reason for this was the "logic of controls": it was believed that commercial banks were not checking properly on whether an item was really outside Schedules A to E. Thus, it was decided that, at the same time as introducing the General Superintendence System, all imports over £ 100 should be checked by the Department of Trade and Supplies to see whether they were truly outside the five schedules.

Effects of Policy Measures

4.55 The measures created chaos. Although a certain delay by General Superintendence can be expected, this has, in fact, been only about ten days, which, although costly, is tolerable. The major bottleneck was the Department of Trade and Supplies. Applications increased to three hundred a day, and the Department fell so far behind that a rush program was made necessary in April to clear a backlog of about 6,000 applications. 2/

4.56 The major problem was these delays, which for small uninfluential firms, especially those outside Nairobi, were as long as four months! Even well-placed firms experienced delays well in excess of a month before their papers even reached General Superintendence. Few of the firms visited by the mission had not been affected by the delays to a greater or lesser extent.

1/ D. S. McRae, op. cit., p. 17.

2/ "The administrative procedures introduced to implement this inspection-service have been overcumbersome, and delays in the processing of forms have led to a serious shortage of a number of commodities in our economy". Budget Speech, June 14, 1973.

4.57 The operation of the system was extremely time-consuming and frustrating to almost all firms. Applications forms were delayed for trivial reasons. (An interesting example is one returned because it was not stated, for a cargo originating in Rotterdam, that it was coming by sea!) Managers had to make many visits to the Department of Trade and Supplies licensing officers -- often with little result.

4.58 Delays of this kind are very costly -- an economic cost which must be added to the direct cost of the Swiss firm itself, which is about £ 1 million a year. A recent study by McRae indicated that about one third of fifty firms interviewed were in serious difficulties, because of raw materials shortages. Our own interviews gave the same picture. Some firms had to close down. Others were operating at reduced levels of activity. 1/

4.59 Because of the delays, firms were using air-freight for items that would otherwise have gone by sea. In addition, firms, especially in construction, were no longer able to air-freight major replacements on a twenty four hour basis, and were holding larger inventories. In general, desired inventories have increased considerably -- with serious potential implications for both the balance of payments, and economic efficiency.

4.60 Yet another problem is that importers break down imports into amounts of less than £1,000 to avoid inspection. This increases handling and shipping charges, which are, like many of the other costs discussed above, losses in foreign exchange.

Reform of the System

4.61 It is open to question whether this system will even achieve its immediate objective. International firms can probably conceal overinvoicing from most eyes, and those who wish to expatriate capital will often be traders who can easily import in values of less than £ 1,000 at a time. Thus, the costs may well have outweighed the benefits so far. Moreover, it is almost impossible to detect variations of up to 5 percent in prices. Such variations must be common.

4.62 The first step has been to reform procedures. Since July 2, 1973, applications for imports other than those in Schedules I to IV no longer have to go to the Department of Trade and Supplies, but can instead be sent directly to the Central Bank. It would be still better if both intermediaries could be bypassed, and invoices were sent directly to General Superintendence. 2/

1/ Details of the cost of delays, and allegations of extensive corruption, appear in the Sunday Nation, April 15, 1973.

2/ This suggestion was made by Mr. T. Tyrell, Executive Officer of the Kenya Association of Manufacturers, in the Daily Nation, May 13, 1973.

4.63 Incentives to overinvoice can be further reduced by increasing duties on low-tariff imports. This would affect companies engaged in tax evasion, and people trying to get capital out through overinvoicing rather than the currency black-market.

4.64 In the meantime, the focus of any system of policing should be on low or zero duty items. Few people are going to tax themselves by overinvoicing on other items, and most people do have a choice, since many imported goods are still subject to low rates of duty.

A Policy for Capital Flight

4.65 There is undoubtedly a relationship between the pressures of Kenyanization on the expatriate business community and the flight of capital. Although there are no hard facts about the extent of capital flight, the Government is convinced that the problem is serious and has, as stated, introduced controls to stem the flow of capital. We believe that these measures are costly and not completely effective and shall suggest an alternative approach to the problem.

4.66 First of all, the vicious circle in the relationship between Kenyanization and the flight of capital should be restated. The pressures of Kenyanization naturally lead to new demands for the repatriation of capital. We are told that the greatest pressure comes from the non-citizen traders who have been displaced under the trading licensing regulations, have no plans to remain in Kenya, and have little interest in holding Kenyan assets other than their own businesses. But it must be assumed that the problem is much wider than the Asian traders, and that other categories of people -- including expatriate personnel who have finished their contracts, many Asian and even African citizens, and foreign businesses generally -- have their own reasons for wanting to convert their savings into foreign exchange.

4.67 The fear of a critical drain on foreign exchange reserves has obliged the Kenyan authorities to impose an increasing range of costly controls on the repatriation of capital. The foreigner with capital to export fears (with justification) that even more stringent controls will apply as time goes on and therefore he tries even harder to "get his money out while he can." But controls may also reduce the rate of Kenyanization since, for example, the non-citizen businessman is unlikely to sell his business to a citizen voluntarily (or to sell shares in his business), if he heavily discounts the chances of realizing his assets in the currency of his choice. Thus, the circle is closed.

4.68 The first step towards an alternative solution is to accept that the capital saved by non-citizens in Kenya is going to flow out of Kenya, in one way or another, at some time or another, whatever controls are imposed. 1/ Short of expropriation of capital, capital repatriation is one

1/ The exchange control regulations accept this fact in the case of emigrants (the critical question being the rate of repatriation) but not in the case of residents.

unavoidable cost of Kenyanizing the economy. Once this fact is faced squarely and accepted, attention can be given to planning how the transfer can be regulated in an orderly manner, with least disruption to the economy.

4.69 The first objective of any solution is, of course, to prevent rapid and disorderly capital flight, and it is clearly not feasible for Kenya to "lift the lid" off the pent-up demand for foreign exchange. There are no reliable estimates of potential capital flight, but the Mission has used a figure of £ 250 million as a rough order of magnitude of the value of assets which might be involved in the Asian Community alone, and of course Kenya cannot afford this kind of capital outflow unless it is spread over a long period of time. The question is how to achieve an orderly transfer of this foreign capital. 1/ As an alternative to the costly controls and regulations which are now employed to slow down capital flight, we suggest that Kenya might use a market mechanism, both to secure a more orderly transfer of capital and to speed up the process of Kenyanization.

4.70 One alternative might be to provide non-citizens with an alternative and acceptable medium of exchange in return for their capital assets, recognizing that neither local currency (which they do not want) nor foreign currency (which the country cannot afford to give them) is an acceptable medium of exchange in the short term. There are, of course, various possibilities for dealing with the problem of capital flight which we do not deal with here. Our purpose is not to argue for any particular solution, but to indicate that there are feasible alternatives to costly controls.

4.71 The important need is to find some way of dealing with the situation, and we wish to reemphasize the seriousness of the basic problems. The transition from expatriate structure to the Kenyanized economy is vital for Kenya. In this process, the techniques of persuasion and incentives are likely to be far more effective than controls and exhortations. It will be very unfortunate if the tail of capital flight is allowed to wag the dog of overall economic management. And lastly, the time for decisive policy action is now because once the controls get entrenched, it will be far more difficult to dismantle them than it is at present.

1/ In view of the vast amounts involved it would seem appropriate for Government to consider how to retain a greater proportion of this capital in the country -- by persuading non-citizens to invest in alternative fields of enterprise, for example. However, there appears to be no action program of this kind.

Conclusion

4.72 Worries about capital flight, tax evasion and overinvoicing have led to a new, and chaotic, control system. It is the Mission's view that the problem can be tackled on several fronts. First, administrative procedures can be drastically overhauled; second, the incentive to overinvoice can be reduced by raising tariffs on low-duty items, and by not taking shares in subsidiaries of major international firms; finally, the pressure of capital flight itself can be reduced by replacing absolute controls with an orderly system of transfer. There are more subtle ways of curing colds than poisoning oneself.

D. CONCLUSION

4.73 It is clear that in the recent past, Kenya moved into an era of controls, which, like mice, bred ever more controls. Hopes for development, not least of exporting, are likely to prove vain in this environment, for already many of the classic problems have arisen, and the possibility of the use of controls is now firmly in the minds of private firms. The Government is aware of the problem and is slowly drawing back from the worst excesses, but it can go much further.

4.74 This Chapter has suggested, at every stage, that alternative methods using incentives can be employed. Such an approach is consistent with Kenyan attitudes, and also the discussion in Chapter 3. Now may be the best, if not the only, time at which a different direction can be tried.

CHAPTER 5. FOREIGN PRIVATE INVESTMENT

5.01 This topic has been most thoroughly covered in the ILO/UNDP Report, ^{1/} and, for that reason, the analysis here will be brief. It will also not attempt to be comprehensive, but will focus on a few key issues. Since many of the subjects discussed have already been considered elsewhere, reference back will be made, as appropriate.

The Role of Foreign Private Investment

5.02 Total private capital inflow has been rather large in the recent past, as can be seen in the table below. Over these three years, 53 percent of net long term capital inflow was private. Although important, it is also

LONG TERM CAPITAL FLOWS
(in \$ million)

	<u>1969</u>		<u>1970</u>		<u>1971</u>				
	<u>Debit</u>	<u>Credit</u>	<u>Net Credit</u>	<u>Debit</u>	<u>Credit</u>	<u>Net Credit</u>	<u>Debit</u>	<u>Net Credit</u>	
Private									
Enterprises	1.9	14.9	13.0	2.1	18.4	16.3	1.7	10.2	8.5
All Public ^{/a}	<u>0.6</u>	<u>7.8</u>	<u>7.2</u>	Cr. <u>4.1</u>	<u>8.8</u>	<u>12.9</u>	Cr. <u>3.1</u>	<u>10.7</u>	<u>13.8</u>
Total	<u>2.5</u>	<u>22.7</u>	<u>20.2</u>	Cr. <u>2.0</u>	<u>27.2</u>	<u>29.2</u>	Cr. <u>1.4</u>	<u>20.9</u>	<u>22.3</u>

^{/a} Includes Government Enterprises, Local Government, and Kenya Government.
Source: Economic Survey, 1972

very volatile, as can be seen, for example, by comparing the figures for 1970 and 1971.

5.03 Another way of evaluating its overall importance is to relate net private long term capital inflow to private capital formation in the monetary economy. Over the same three years the proportion has been 25, 24, and 11 percent respectively. In the years 1967 and 1968, the proportions were 18 and 19 percent. Thus, private net capital inflow has been extremely important in financing the balance of payments and, at the same time, private investment.

5.04 The two most important sectors of total private activity recently financed by foreign private investment are tourism and manufacturing. Most

^{1/} See ILO/UNDP Report, op. cit., pp. 18, 101, 178-9, 184-192, 437-457 and 463-468.

detailed data are for the latter. An UNCTAD paper 1/ estimated that private long-term capital inflow accounted for 35 percent of capital expenditure in manufacturing in 1966, 33 percent in 1967, and 42 percent in 1968. An even more significant figure, however, is the ratio of manufacturing investment involving foreign capital to total manufacturing investment. The ILO/UNDP Report, 2/ using Hermann's 3/ data, calculated this ratio to be about 60 percent. This may be regarded as an indication of the extent of foreign control in manufacturing. (These data are not thought very accurate, so the figures should be seen as indicative only.)

5.05 Foreign controlled firms are especially important in tourism, petroleum refining, tobacco, cement, metal products, and textiles. Foreign production has a major role in many other industries, including miscellaneous foods, footwear, paint, soap, and miscellaneous chemicals.

Government Attitudes and Incentives to Foreign Private Capital

5.06 Basic Policy. "The Kenya Government has encouraged foreign investment since the attainment of national independence, although always subject to certain controls." 4/ In fact, the government's attitude has been decidedly ambivalent, desiring, on the one hand, the inflow of funds and associated skills and entrepreneurship, but wishing, on the other hand, to secure "an active..... and growing participation of Kenya citizens in management and ownership of industry", 5/ and an increase in government participation to secure control over the activities of the foreigners. In general, however, the requirements of growth have come first, as has been stressed in the several Plan documents, with results on the level of foreign investment and control of enterprise activity discussed above.

5.07 However, one government policy towards private enterprise is partly explained by its basic attitude, namely its desire to take equity in new enterprises through the I.C.D.C. It is the government's belief that this

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- 1/ L. Needleman, Sanjaya Lall, R. Lacey, and J. Seagrave, Balance of Payments Effects on Foreign Investment: Case Studies of Jamaica and Kenya, (UNCTAD document TD/B/C.3/79/Add.2/Corr.1, 30th June 1970; mimeo; cited in I.L.O., op. cit., p. 441.
- 2/ ILO/UNDP op. cit., p. 442.
- 3/ B. Hermann, Some Basic Data for Analysing the Political Economy of Foreign Investment in Kenya, Discussion Paper No. 112, IDS Nairobi, 1971. His data were derived from the Registrar of Companies and are, therefore, legal, not actual figures. Too great faith should not be placed in the details, therefore.
- 4/ ILO/UNDP Report, op. cit., p. 184.
- 5/ Development Plan 1970-74, p. 304.

increases its control over foreign firms. Of course, the policy also has a certain incentive effect for foreign investors - especially if the finance provided is in the form of low interest loan capital.

5.08 Incentives. 1/ The important incentives are undoubtedly the freedom to expatriate profits and industrial protection. These are quite attractive to foreign firms, and, in combination, provide plentiful opportunities to expatriate foreign exchange which has not been earned. The Foreign Investment Protection Act of 1964 provides the basic guarantees. It gives freedom to expatriate profits and "the approved proportion of net proceeds of sale" to companies having an "approved Status Certificate", which is granted by the Minister of Finance at the suggestion of the New Projects Committee. However, each individual transfer of funds requires Central Bank Approval. In addition, Kenya has been very liberal about approving payments of royalties, or contributions to parent company overheads, or research and development.

5.09 Profits tax is 40 percent and a 12.5 percent withholding tax is levied, in addition, on dividends paid by private and public companies, but branches of foreign companies have, until recently, not paid the withholding tax.^{2/} The most important tax allowance is the 20 percent capital cost allowance in the first year of operation, which is available to all firms.

5.10 As discussed extensively in earlier sections of the annex, considerable protection is granted to manufacturing firms. Individual companies are able to negotiate special privileges in the form of duty refunds and quantitative restrictions. In fact, it appears that foreign firms are securely lodged where protection is highest. ^{3/}

5.11 Availability of Credit. The government has recently restricted the access of foreign firms to cheap finance from the banking system. However, finance can still be fairly easily secured from I.C.D.C. (which in some years have been greater than the equity brought in by the enterprises), from other financial institutions, and from the local stock exchange (with the approval of the Capital Issues Committee). In all, some 30 percent of all local private and public capital invested in manufacturing over the 1964-70 period went into foreign-controlled companies. ^{4/} Fifty-three percent of the

^{1/} The main sources are the ILO/UNDP Report, op. cit., pp. 437-440 and A Guide to Industrial Investment in Kenya, Ministry of Commerce and Industry, 2nd Edition, 1972, especially pp. 76-84.

^{2/} In the 1973/74 Budget, a differential tax on branches was proposed. In any case, the past incentive to organize as a branch has been offset, to some extent, by the fact that I.C.D.C. has not dealt with branches, nor provided them with funds.

^{3/} ILO/UNDP Report, op. cit., p. 446.

^{4/} Ibid., p. 453, from B. Hermann, op. cit. (for qualification, see footnote 3 to para. 5.04).

resources, excluding retained earnings, in new investments by foreign-owned enterprises were domestically supplied. ^{1/}

5.12 This ready supply of domestic funds to foreign enterprises is an important incentive, but it also has crucial implications for their evaluation. The return to the project may well exceed the returns on the domestic capital invested.

How to get the Maximum Advantage from Foreign Private Investment

5.13 The issue of how much foreign investment to have is, in the last resort, a political one, and is not discussed here. The more immediate question is how to get the greatest possible benefit from such investment. Its enormous importance in Kenya, combined with the considerable incentives given it, raise this question very forcibly indeed. It is not unreasonable to say that, in some respects, the present environment provides an object lesson in how not to get much advantage from it at all.

5.14 The potential advantages of foreign investment are essentially two: the first is the capital inflow, which in Kenya is by no means an insignificant consideration; the second is the supply of skills, and technical information. There can be no question that these advantages can be made actual in Kenya.

5.15 Trade Policy. As has been shown in Chapter 3, investors in manufacturing are expatriating unearned foreign exchange through the protection system. Essentially a transfer from agricultural producers to manufacturing is taking place. Thus, the first and most important reform in the incentives to foreign private investment must be in the trade policy system. Without it, what amounts to pure 'exploitation' in a classic sense, will continue. Moreover, this exploitation is the direct consequence of government policies.

5.16 Failing such a reform, the only projects that can be assumed to be economically viable (or at least not to make the country worse off) are those which are overwhelmingly in exports. Certain agricultural processing activities come in this category as do many tourist projects. It is, of course, perfectly conceivable that they are not earning Kenya as much as is possible, because of illegal currency activities, overinvoicing of imports, or underinvoicing of exports, but unlike some manufacturing projects, they are very unlikely to be net losers of foreign exchange.

5.17 The trade reform would allow -- indeed encourage -- foreign firms to concentrate on what they probably know best, namely exporting. Since they are based overseas, they will have ready first-hand information of these markets. A strategy of using foreign firms to supply final processing and marketing of Kenyan produce would take greatest advantage of their true comparative advantage. In the reformed policy system, such activities would no longer be penalized, while import substituting activity would no longer be especially protected.

^{1/} Ibid., p. 452, from B. Hermann, op. cit. (for qualification, see footnote 3 to para. 5.04).

5.18 The trade policy reform would also dispose of the very dubious practice of giving "infant industry" protection to subsidiaries of major international firms. Firestone, for example, is no infant, and, if it is unprepared to bear the costs of setting up a new operation, it is not at all clear why the Kenyan consumer should. Since it is the desire of the Kenyan government to promote infant industries, it should remember that the true infants are its own entrepreneurial and industrial class. Protection in the domestic market should, as far as possible, be given only to them, as is done now for Kenya Industrial Estates.

5.19 The trade policy reform would also substantially reduce incentives to overinvoice. As has been shown above (paras. 4.42-4.50), incentives to overinvoice depend usually on the relation between tariffs and the corporation tax. (Additional taxes on management fees and royalties equal to the uniform tariff make sense, since these can be regarded as traded inputs.) ^{1/} Given Kenyan manufacturing's high share of imports in costs, this reform would gain, rather than lose, revenue.

5.20 It appears that the grossest defects in the foreign enterprise contribution to Kenya are the result of trade policy. These defects can be removed, and additional benefits, such as a greater orientation by foreign firms to exports, can be secured through a thorough reform. At the moment, every incentive is provided to foreign firms to expatriate foreign exchange they have neither earned nor saved, to overinvoice imports, and to sit snugly behind protective walls. These incentives are within the power of Kenya to change. The result may be smaller investment in total, (although this is not necessarily so, as is shown by the high foreign investment for export in countries like Brazil, Israel, and Korea,) but the investment would at least be of benefit to Kenya.

5.21 Local Participation. If the allocation of functions were made on the basis of comparative advantage, most big businesses would be under foreign ownership, while most Kenyans will be in small business. In due course, the line would become blurred as successful African businessmen move up the economic ladder. However, it is undeniable that progress will be slow if left to natural processes, and, as a result, for obvious and compelling political reasons, the Government has tried to accelerate the process.

5.22 So far, Kenya has fostered local participation by encouraging African businessmen and by extending financial participation in foreign companies, either by the State, or to a much lesser degree, by private individuals. In fact, State participation in equity has been the major means of Kenyanizing ownership of the large scale modern sector.

5.23 The Kenyan Government has followed a cautious and scrupulously fair policy in nationalizing industries or acquiring shares, and its policy has

^{1/} The Government now imposes a 20% withholding tax on royalties and management fees.

done much to reinforce the confidence of investors. Some degree of State participation in new enterprises has become accepted and even desired by foreign investors. Yet such participation can be very costly, for several reasons. First, as demonstrated above (para. 4.47), the provision of domestic equity increases the incentive to overinvoice, and thereby to expatriate the return on local capital. Second, the provision of domestic loans at low interest rates also allows foreign firms to expatriate returns on local capital. Third, the more local resources are available, the lower the incentive to the foreign firm to bring in capital. Since capital is scarce overall, funds are thereby taken away from areas where private foreign finance is not readily available, such as agriculture or small scale business or social services. Moreover, should private firms be forced to borrow more overseas without a Government guarantee, the risks of project failure are not borne by the **Government.** 1/

5.24 The most direct and obvious cost of state participation in private enterprise is, of course, budgetary and, in the case of acquisition of foreign-held shares, on the balance of payments. Quite a different and very serious cost to state participation, however, is the growing management burden imposed on senior Government personnel. State participation (however small) usually means a member on the board, and this invariably creates yet another demand on the time of senior government officials, whose opportunity costs are very large indeed and who are already overburdened. As a general principle, it is clear that the civil service has a difficult enough job in trying to run the public sector and its complex machinery without intervening in the private sector. This is one of the reasons why the Mission has expressed preference for alternatives to direct intervention for influencing the behavior of the private sector.

5.25 What are the economic, as opposed to political, benefits of local participation? First of all, in some instances, local participation may be a necessary condition for a foreign enterprise to establish itself at all in Kenya, even when the project is economically and financially viable. The firm may be cautious, and if the benefits to the country are sufficiently great, it may be sensible for Government to participate with equity or loan funds to clinch the investment. Second, the Government may think the provision of equity is a useful way of increasing Kenyan "control" over the firm's activities. This latter argument is dubious. Failing direct control over management, it is extremely difficult to check on what a firm is doing. In general, therefore, it seems economically wise to limit participation by the State although the political reasons for it must be understood and accepted.

1/ There is one exception to this argument: namely, when Government has access to a perfectly elastic supply of foreign funds at interest rates below those which foreign firms must pay. In this case, it may make sense to borrow itself (since it foregoes nothing), bear some of the project risk, and charge the foreign firm what it would have had to pay. In this way, the Kenyan authorities can get a little rental surplus from their privileged access to foreign funds. This theoretical possibility is very unlikely to occur in practice. Thus, local resources should be limited.

5.26 Tax Reform. Apart from the discussion above on trade policy, there is no further question about tax incentives in relation to foreign investment. The refusal to offer tax holidays seems very sensible. Because of double taxation agreements, they are usually no more than a gift of tax to another country.

5.27 Investment Appraisals. The recommendations made by the ILO/UNDP Mission for the improvement of the system of negotiation with foreign investors are sensible. 1/ An important first step is to improve the economic appraisal of all proposed investments. This is essential, while trade policy remains unreformed, since many uneconomic projects are financially very attractive. The purpose of using a precise and rigorous cost benefit analysis is to ensure rejection of all projects that do not give a return to national resources at least equal to the opportunity cost of capital. Of course, in the event of a complete reform, as a result of which economic and financial returns are more nearly equated, improved economic appraisal would be largely unnecessary.

5.28 The exact system to be used is not very important, except that it should be complete, and that tradeable goods should be evaluated at border prices. 2/ It will be important for projects involving Kenyan, as well as foreign capital, to derive a return to national capital. Even viable projects can be unviable, from the national point of view, if excessive profits are expatriated. A major discrepancy between overall and national economic returns is a warning signal that protection is too high, or that some other aspect of the project, such as the cost of domestic loan funds, should be renegotiated.

5.29 Factor Intensity. This seems to be one area where "getting the most out of foreign investment" does not pose any particular problem. The ILO/UNDP Report indicates that, if anything, foreign firms in the same lines of activity as domestic firms are more labor-intensive. 3/ Thus, any problem applies to large-scale activity as a whole.

5.30 It remains the case that the influence of foreign techniques and products on large-scale manufacturing, both foreign-owned and domestic, must affect the factor intensity of the sector. There is no doubt that informal activity is substantially less capital intensive. However, from a policy point of view, this raises questions not about the role of foreign investment in the formal sector, but the role of the formal sector -- influenced by foreign techniques, as it is -- in the economy as a whole. The issue is, essentially, what is the net benefit of having a formal and, therefore, relatively capital intensive sector at all in an economy like Kenya's.

1/ ILO/UNDP Report, op. cit., p. 189.

2/ Domestic Resource Cost, Social Effective Rate of Protection, Net Present Value, or Internal Rate of Return would all be acceptable. All of these are vastly superior to calculations like value added generated, or employment per unit of capital employed.

3/ ILO/UNDP Report, op. cit., p. 450.

5.31 Conclusion. It appears that Kenya can reap much greater benefits from foreign investment than at present. The most important changes are in trade policy -- failing that, in appraisal technique -- and in the willingness to limit foreign firms' access to local resources. Changes in the directions suggested above will provide incentives to foreign firms to act to the greatest possible extent in the interests of Kenya.

How to Attract Foreign Investment

5.32 The above section was concerned with the creation of an environment which will get the most out of foreign investment. This section asks how to attract the most foreign investment, given that environment. What are the policies most annoying to foreign firms who might consider establishment in Kenya? How can they be changed? These are very important questions, since the Kenyan authorities are keen to attract more investment, seeing it -- rightly -- as a necessary condition for fulfilling their rather ambitious plan targets.

5.33 On the basis of the Mission's discussion with foreign private firms in Kenya, it is clear that a very few policies -- most already discussed above -- are regarded as very hampering. A major problem has been the exchange controls on imports. These have been annoying first, because they were unforeseen, second, because they are, in themselves, inconvenient and, third, because they have involved firms in extensive bureaucratic tussels. All these factors amount to extra cost and decreased security of operation. Another often mentioned difficulty is that of getting foreign exchange for business travel. Finally, and perhaps the most frequently cited of all, is Kenyanization policy. The bureaucratic way it is carried out, the lack of advance notice, the apparent foolishness of many decisions, has undoubtedly created immense annoyance. Firms do not like fighting with extensive bureaucratic regulation of this sort.

5.34 All these policies may be excellently intentioned, and even -- although it is dubious -- be the best possible in the circumstances. However, there can be little doubt that they are fairly powerful disincentives to new investment by established firms, and can, therefore, be expected to be even greater deterrents to those now sniffing at the edges.

5.35 The reform of trade policy will affect the composition and possibly the size of foreign private investment. The question of incentives arises. Although the most important constraints on foreign investment are those discussed above, it may well be that some positive incentives should be developed to offset the reduction in protection in the home market. A duty-free zone would be a possibility. However, it will not necessarily be the case that a change in trade policy will lead to a reduction in foreign investment, or in industrial investment overall, so further incentives may well be unnecessary. In any case, this is an appropriate area for further work.

5.36 In addition, it is an opportune time, as Kenya enters the second decade, to issue new guidelines to the foreign investor. There is already a clearly-formulated policy towards the overseas investor in the urban formal sector which could be modified in ways which we have discussed. But such guidelines need to go further than manufacturing or mining or tourism and should be extended to other sectors, particularly agriculture. We believe that agriculture -- and especially large scale agro-business integrated with small farm production as discussed elsewhere -- is an obvious field for greater foreign investment. Despite the political problems associated with foreign use of land, this is an area of great potential benefit, and there is need for a clear statement of policy -- a charter for the agricultural investor -- to replace the present atmosphere of uncertainty and ad hoc decision making.

The Implications of Foreign Investment for Savings

5.37 The existence of such a large foreign stake in the private sector has important implications for the argument that greater capital-intensity entails greater saving and so growth. In the first place, as was argued in Chapter 3, greater capital intensity need not mean higher profit shares, since the wage rate is by no means invariant between techniques, firms, or sectors. 1/ Second, if movement to a highly capital-intensive sector means more foreign investment (and foreign firms do appear to be concentrated in more capital-intensive activities), then a substantial portion of the extra profits will be expatriated. As the ILO/UNDP Mission has shown, an arithmetic average of savings out of profits on foreign equity was only 58 percent for the years 1967-70. 2/ Thus, 42 percent of incremental profits would be expatriated.

5.38 This point by no means exhausts the disadvantages of such a strategy, since it will reduce employment in the short run, and may even do so in the long run, if subsequent investment is increasingly capital-intensive. 3/ Moreover, it is possible to raise savings by other means. However, the fact of foreign investment tends to break the logic of the argument at an early stage. Movement from a low profit domestically-owned sector to a high profit foreign-owned sector may well not increase investible resources to Kenya. (Movement within the foreign-owned sub-sector from low to high profit activities will increase investible resources if propensities to retain are constant.)

Local Entrepreneurship and Innovation

5.39 Two fundamental policy issues stand behind any decision about the acceptability of foreign investment. These issues concern Kenya's basic strategy and the implications of Kenya's great dependence on foreign skills and entrepreneurship.

1/ See also, ILO/UNDP Report, op. cit., pp. 135-137.

2/ ILO/UNDP Report, op. cit., p. 136.

3/ Ibid, p. 137.

5.40 The first point is that foreign investment's domination of the formal sector may have turned many enterprising Kenyans into managers, not entrepreneurs. 1/ As we have noted in Volume I, the greatest deficiency in Kenya is entrepreneurship, and it may be questioned how fast and how successfully local businessmen can be encouraged as long as they operate in the shadow of large and well-established foreign firms. Some deliberate restrictions on foreign enterprise might possibly be justified, even at the expense of some growth, if these could lead to a faster development of independent Kenyan entrepreneurship. But any policy of restricting non-citizen activity needs to be formulated with great care, and its effects calculated very carefully, lest it should do more harm than good. The Mission feels that the foreign investor can continue to make a valuable contribution to Kenya's development, and that this contribution could be much greater than in the past. However, in determining future industrial strategy, it will be necessary to consider how far foreign enterprises can be made more supportive of (or at least not detrimental to) the development of local businesses.

5.41 We feel that a formula for co-existence can be found. First of all, at the most basic level of investment policy, the foreign firm, like the African businessman, should be encouraged to enter those fields in which it appears to have a comparative advantage, especially in providing the technical skills, access to markets and forms of managerial talent which simply do not exist in Kenya. If foreign and Kenyan businessmen are encouraged through suitable policy instruments each to operate in his own field of advantage, the extent of direct competition can be reduced substantially, if not eliminated, and the Kenyan economy can benefit from the contribution which both sectors have to make. 2/

1/ P. Marris and A. Somerset, op. cit., p. 4. "The largest concerns in Kenya are mostly European-owned or branches of international companies. They recruit and train African managers and may co-opt distinguished Africans onto their boards, but they do not depend on African entrepreneurship. This perhaps is their weakness. They tend to pre-empt only the most obvious opportunities in conditions contrived to favor their chances by a government anxious for their investment. The element of entrepreneurship is diffused among prospective investor, government and supportive agencies, who may manipulate the economy to accommodate a preconceived pattern of organization. Such companies can remain an enclave of sophisticated management, poorly integrated with the rest of society and stultifying as much as encouraging its potential economic vitality."

2/ Taking the longer view, a larger foreign-owned sector now can of course mean a larger sector to Kenyanize later. There are obvious benefits to be gained if Kenya can induce foreign investors to establish enterprises in Kenya, provide the necessary know-how, eliminate the teething troubles, find the markets, train the labor and then hand over smoothly-operating businesses to Kenyan ownership and control.

5.42 Once the general rôle of foreign enterprises had been clarified, it would be possible, in our opinion, to go further towards making foreign and local businesses more complementary. We believe that foreign enterprises can be made more complementary and supportive in both direct and indirect ways. For example, there is some scope, as the ILO/UNDP Report suggests, for large scale business to sub-contract to smaller firms directly. 1/ But we believe there is much greater scope for ensuring that foreign enterprises fit in to the whole strategy for developing small-scale African enterprise. For example, foreign investment in agro-business can provide a market outlet for expanded smallholder production, and in the manufacture of intermediates, foreign firms can reinforce, rather than displace, local technology. 2/

Conclusion

5.43 Foreign private enterprise and investment are extremely important to Kenya, and indeed, essential to a strategy of rapid growth based on formal activity. However, improvements in the policy environment could increase their contribution to Kenya, which, in some activities, is negligible, and also reduce the incentive to various fraudulent acts. Moreover, further changes in the direction of rethinking policies of control and interference would greatly enhance the already considerable attractions of operation in Kenya. However, behind all this is the basic issue of the effect of reliance on foreign enterprise on the development of the extremely tender plant of domestic entrepreneurship and innovation. As far as possible, formal business, and especially foreign business, must be made supportive of emerging Kenyan entrepreneurs. It is quite possible that the current policy could prove very short-sighted in the long run, and this consideration makes it even more important to determine a proper role for the foreign private investor in Kenya in the future.

1/ See ILO/UNDP Report, op. cit., Chapter 13.

2/ For example, by manufacturing building components which are suitable for small and labor - intensive building contractors to use. This complementarity with local industry should be an important consideration in project appraisal.

CHAPTER 6: CONCLUSIONS

6.01 The analysis of the key issues which, in the opinion of the Mission, now face Kenya's private sector has elaborated on a few major themes. In this conclusion, rather than repeat detailed points, the basic themes will be focused upon, in order to illustrate both the fundamental policy choices, and the mission's understanding of the private sector's environment and its effects. The themes are three, namely incentives versus controls, the costs and benefits of formal urban activity in the present policy environment, and the basic trades-off in a reformed environment. The issues will be taken in turn.

Incentives versus Controls

6.02 The Kenyan private sector is "semi-controlled", but, in the Mission's view, the degree of control -- over prices, trade, foreign exchange, and so forth -- is increasing. It appears from detailed analysis that administrative interventions have rarely been fruitful, and have often been counterproductive. Although, in theory, mountains might be moved by such devices, there is no evidence to indicate they will be, and much in past experience to indicate they will not.

6.03 It seems especially appropriate to Kenya, which is a country with some commitment to maintaining a private enterprise system, to reconsider this line of policy, before it goes much further. The controls that have been introduced will not only inevitably breed more controls, but they will also demand the efforts of an increasing proportion of the skilled manpower of the country. It is far from obvious that Kenya's development will benefit from having one half of its skilled manpower policing the other half.

6.04 At every point -- for example in the control over imports, over-invoicing, and wages -- this paper has suggested that there exist methods based on price incentives, which would make firms -- in their own interests -- do what the government wishes. The detailed working out of such incentives is an important task, but the necessary first step is to make the basic commitment to use them if possible.

6.05 The formal sector can, in the Mission's opinion, given the right price incentives, look after its own, and Kenya's interests, extremely well without further assistance. The first priority for the use of government manpower and energies are those areas of the economy, such as small scale agriculture, the informal sector, and social services, which cannot. Therefore, this recommendation of the Mission is not at all a suggestion for the Government to withdraw from the development field, but, rather, to focus its scarcest resources on the areas where development assistance is most urgently required. The effort to control the formal sector in detail is wasteful of these scarce resources.

Policy Reform in the Urban Formal Sector

6.06 The urban formal sector is operating in a distorted environment, largely because of trade, wage, and credit policy, that imposes costs in terms of its own efficiency, and even greater costs on the rest of the economy. Many of the problems that concern the Government most, such as unemployment, rural poverty, and the slow growth of non-primary exports, are a direct consequence of (or are being exacerbated by) this policy environment. It is almost certainly true that, in present circumstances, formal activity is acting against, rather than in support of, most of Kenya's major development goals.

6.07 A reform in trade policy is the most important step towards improving the situation. Through the deflation of urban real wages, and an increase in rural real incomes, such a reform should go at least some of the way towards curing the problems created by the "wage gap". At the least, the urban formal sector itself should be more efficient and its external costs be substantially reduced.

Some Basic Trade-Offs

6.08 Even if a substantial reform of the policy environment were to take place, however, the Kenya Government would still be left with some basic choices. These choices have been alluded to at several points above.

6.09 A strategy of concentration on the formal sector will inevitably conflict with the goal of rapid Kenyanization. Formal activity requires, to a great degree, the skills which, at present, only foreigners can supply. Furthermore, any strategy of rapid growth -- even one less 'formal' in orientation -- will require many expatriates in advisory and managerial positions.

6.10 The formal urban sector is almost certain to continue to provide real wages above those in the rest of the economy. Because the informal urban sector is, in this situation, a waiting ground for formal sector jobs, any encouragement given to the informal sector will increase its size but not the incomes of those within it, unless there is also a reduction in the wage gap. Returns will otherwise be driven down by migration, and attempts at informal sector development will mainly increase the scale of urban distress.

6.11 Finally, there may be a trade-off between formal foreign-dominated activity and the development of Kenyan indigenous entrepreneurship. Undoubtedly, in an appropriate environment, the formal sector can provide considerable growth, especially in tourism and manufacturing. If the foreign firms take advantage of profitable opportunities open only to their abilities, growth will be higher than without them. Nevertheless, appropriate relations between large-scale foreign formal businesses and Kenyan entrepreneurs must be developed, so that the latter are supported, not stifled.

APPENDIX 1: A NON-TECHNICAL EXPLANATION OF EFFECTIVE PROTECTION

1. In this Appendix an attempt is made to explain what effective protection is and why it is important. The purpose is to make the discussion of the Annex comprehensible to those without previous contact with these tools of economics. ^{1/}

2. The most useful explanation is an example. We assume the existence of a small country which exports tea, and imports a range of manufactured goods. The equilibrium exchange rate between the domestic currency (the Ror) and the US dollar is Ror 2 to \$1, and there are no tariffs on any goods. Among the imports are trucks, which cost the country \$10,000 in foreign exchange, or Ror 20,000 each. The country would like to produce the trucks domestically, but would have to import the components to make them. These components cost \$8,000 (or Ror 16,000) per truck, including freight and handling charges. Local assembly costs Ror 5,000 in labor costs, there are no other variable costs at all, and the local cost of production would be Ror 21,000.

3. Since all trucks are assumed identical, domestic consumers will not pay more than the price of the freely-importable, duty-free foreign truck. In free-trade, therefore, there is no profit in constructing trucks domestically, since the margin of Ror 4,000 between the domestic price of trucks and the cost of the imported components does not even cover labor costs, let alone earn any profit.

4. Nevertheless, the government is determined to save foreign exchange by proceeding with a strategy of import-substitution. It decides to give protection to the industry, so as to give a rate of return of 10 percent on capital which is sufficient to induce domestic production.

5. To determine the required protection it needs to know more about the capital requirements of the industry. As a matter of fact, the factory, all of which has to be imported, costs \$10,000,000 or Ror 20,000,000. Once in full production, the factory will turn out 500 trucks annually. In order to get his 10 percent return, the owner must make Ror 4,000 on each truck or Ror 2,000,000 annually in profit.

6. Assuming labor is readily available at the going wage, a profit of Ror 4,000 per truck implies a domestic price of Ror 25,000. To achieve this price, the government imposes a nominal rate of tariff on trucks of 25 percent. The situation would then be as follows:

^{1/} A major textbook reference is M. Corden, The Theory of Protection, Oxford, 1971.

Components of the Price of Trucks to Consumers
(Ror)

	Domestically Produced	Imported	
Components	16,000	Truck	20,000
Labor	5,000	Duty	5,000
Profit	4,000		
Total	25,000		25,000

7. So far everybody appears to be happy--the government, because it has saved foreign exchange (Ror 4,000 per truck, as a matter of fact), and the owner because he is making 10 percent. Everyone is happy except the consumer who is paying Ror 5,000 more for his trucks, and the economist.

8. The economist asks what the true gain to the country is. To do this he estimates effective protection and viability at world prices. What he means by these terms and why they matter must be elaborated.

9. To explain effective protection, one must first consider the concept of value added. The value added in a process is the difference between the cost of the materials brought from outside into the factory and the sales value of the product. It is clear enough that the value which the process adds to the basic materials is the difference between these two prices. However, in the case described above, there are two different ways to measure value added. In domestic prices the value added is Ror 9,000, or the difference between the price of the output (Ror 25,000) and of the components (Ror 16,000). In foreign exchange, however, the value added is \$2,000 or Ror 4,000. Effective protection concerns the difference between these two.

10. The concept of value added has two important aspects. First, as is clear from the example, the value added in domestic prices is equal to the returns to the two so-called "primary factors of production"--labor and capital (i.e., the factory)--which are engaged directly in the activity. Second, the value added in world prices is equal to the foreign exchange saved by the activity. In this example the saving is \$2,000, the difference between the cost of the truck and the imported components.

11. Effective protection is defined as measured domestic value added minus world value added divided by world value added. In the example, this comes to 125 percent $((\text{Ror } 9,000 - \$2,000)/\$2,000)$. This means that domestic value added is 125 percent larger than world value added. The concept is

similar to that of nominal protection, except that, instead of assessing protection on the price of the good--25 percent in this example--, it assesses protection on the value added, and this is five times as great.

12. From an economic point of view effective protection is a more meaningful measure than nominal protection. The reason is that it measures protection given to the domestic factors of production, and, therefore, the attractiveness of the activity. That attractiveness is the motive power leading to reallocation of resources. In the example, it has been shown that a 125 percent effective protection was required to achieve a 10 percent rate of return on capital, which was the minimum needed to start the factory. (Effective protection can also take account of tariffs on imports. In our example a 10 percent tariff on the components would reduce domestic value added to Ror 7,400 and effective protection to 85 percent. Thus, the protection to the value added would be lowered.)

13. Where does the "additional" value added come from? The answer is from the consumer. In comparison with the previous situation, when trucks cost Ror 20,000, they now cost Ror 25,000. The additional Ror 5,000 is a "tax" on the consumer which is transferred to the producer. This Ror 5,000, in addition to the world value added of Ror 4,000 provides the domestic factors of production with their Ror 9,000. Alternatively, if the government had already previously imposed the tariff, the Ror 5,000 is a transfer from government revenue. In both cases the additional value added does not imply an increase in GNP but a transfer from one section of the community to the producers of the protected goods! The other sections are made correspondingly worse off. A corollary is that the domestic value added at the official exchange rate far overstates the foreign exchange saving of the project--by 125 percent, in fact. The Ror 9,000 of value added saves exactly \$2,000, giving an exchange rate for the project of Ror 4.5 to \$1. In other words, Ror 4.5 of domestic resources saves \$1.

14. The last idea leads naturally to a consideration of viability. The government has arranged a transfer to the producers of trucks which makes the project financially profitable. Viability, however, is a measure of the overall benefit of this policy to the community. A simple explanation would run as follows: when the labor is drawn from other activities, production in those activities will fall somewhat. Similarly, when capital is invested in the truck factory it is withdrawn from another potential use. Let us suppose the labor required to make a truck is five man-years. Let us also suppose that one man-year in tea production produces \$300 (Ror 600) worth of output. By withdrawing 5 man-years of labor from tea, production will fall by \$1,500 (Ror 3,000), which is 60 percent of the wage paid in the truck factory. If the potential rate of return of capital in tea was 10 percent, or the same as in the truck factory, Ror 10 of capital invested in trucks would lose Ror 1 of tea output every year. Thus, for the Ror 20,000,000 (\$10,000,000) invested in the factory the loss would be Ror 2,000,000 (\$1,000,000) or Ror 4,000 (\$2,000) per truck.

15. It is now possible to make an overall foreign exchange balance, as is shown below.

Value Added in World Prices:	\$2,000
Foreign exchange cost of tea foregone by transferring labor:	\$1,500
Foreign exchange cost of tea foregone by transferring capital:	\$2,000
Total Foreign Exchange Saving:	-\$1,500

Taking into account the value of output foregone through the transfer of factors of production, it appears that this project loses \$1,500 of foreign exchange over the situation when the labor and capital is occupied in tea. The project is non-viable. The 125 percent effective rate of protection permits the establishment of a project which makes the country's foreign exchange balance worse! However, if the labor had been totally unemployed, so that no output was foregone when it was transferred, the project would have been just viable--earning exactly 10 percent on capital.

16. This result is by no means the only possible one. For example, the project may have been viable. If the components had cost \$6,000, the project would have made \$500 per truck for the community. The high effective protection would have offset the fact that the financial cost of labor--Ror 5,000 per truck--overstates the economic cost of Ror 3,000 per truck. (The project was viable but unprofitable, and, therefore, required protection.) 1/ If the components had cost only \$5,500 the effective protection would have turned a project already earning 10 percent on capital into one earning 22.5 percent. 2/ If the components had cost \$11,000 we would have an example of a hopelessly non-viable project--one with negative world value added. Even if labor and capital were "free," the country would be worse off by having such a project.3/ (Such extreme cases are not rare--they have been found in every study, including those done on Kenya.) Finally, the tariff on inputs might have been 60 percent, which in the example where components cost \$5,500 would have made measured domestic value added Ror 7,400, and effective protection -18 percent.4/ In this case a viable project economically would be financially unprofitable, earning only 6 percent on capital. (Such a situation could easily arise if the components were domestically manufactured behind a 60 percent tariff wall.)

17. The measures of effective protection and viability indicate what government is doing and analyze the efficiency of its policy. In the Kenya study effective protection is found to be highly negatively correlated with viability. Thus, protection does not simply offset distortions in the labor market, or make more profitable activities which are already viable without protection. Protection makes possible activities which are non-viable, or in other words, are net losers of foreign exchange. The external benefits of such projects have to be very large indeed to offset this great cost.

1/ See table attached below, lines 2a and 2b.

2/ See table attached below, lines 3a and 3b.

3/ See table attached below, lines 4a and 4b.

4/ See table attached below, line 3c.

SOME COMBINATIONS OF TARIFFS AND PRICES OF COMPONENTS

Cost of Components	Tariff on Output %	Tariff on Input %	Domestic Value Added Ror	World Value Added \$	Effective Rate of Protection %	Domestic Profitability (Rate of Return on Capital) %	World Price Viability (Overall foreign exchange balance) \$
1a) \$8,000 (Ror 16,000)	0	0	4,000	2,000	0	- 2.5	-1,500
1b) \$8,000 (Ror 16,000)	25	0	9,000	2,000	125.0	10.0	-1,500
2a) \$6,000 (Ror 12,000)	0	0	8,000	4,000	0	7.5	+ 500
2b) \$6,000 (Ror 12,000)	25	0	13,000	4,000	62.5	20.0	+ 500
3a) \$5,500 (Ror 11,000)	0	0	9,000	4,500	0	10.0	+1,000
3b) \$5,500 (Ror 11,000)	25	0	14,000	4,500	55.6	22.5	+1,000
3c) \$5,500 (Ror 11,000)	25	60	7,400	4,500	- 17.8	6.0	+1,000
4a) \$11,000 (Ror 22,000)	0	0	- 2,000	-1,000	0	-17.5	-4,500
4b) \$11,000 (Ror 22,000)	55	0	9,000	-1,000	n.a. /1	10.0	-4,500

/1 Effective rates cannot be calculated for negative value added industries.

- Note: 1. Financial labor cost per truck is Ror 5,000, and economic labor cost is Ror 3,000 (\$1,500).
 2. The opportunity cost of capital is 10 percent, both economic and financial.
 3. The world price of a truck is \$10,000 (Ror 20,000).
 4. The total cost of the factory is \$10,000,000 (Ror 20,000,000).
 5. The factory produces 500 trucks per annum.

APPENDIX 2: MEASURES OF PROTECTION AND VIABILITY

1. The purpose of this note is to review the studies of effective protection used in the Annex, and to indicate the confidence it is possible to place in their general and specific results. Thus, the first section will deal with questions peculiar to the studies, while the second will be concerned with the usefulness of all studies of this kind.

Studies of Effective Protection and Viability in Kenya

2. The most important source for the Annex was the study done by Phelps and Wasow. 1/ A subsidiary source, employed in the analysis of the effects of transfer taxes, was a paper of R. Reimer. 2/

3. The Phelps and Wasow study derived its input-output data from the 1968 survey of industry. Evaluation was done for all individual firms employing more than fifty people. Thus, the study was extremely disaggregated. Domestic prices were derived from inter East African trade statistics, and unit values of firms' inputs and outputs. World prices were derived from East African export prices, Japanese import and export prices (after a transport cost adjustment), or, failing all else, tariff deflators. Capital stock data were derived from the 1968 survey, as were data on the total wage bill. The division between skilled and unskilled labor originated in the 1969 Enumeration of Employment. Skilled workers were defined as those earning more than Sh 500 per month. The adjustment for non-traded goods was done by applying the average nominal rate of protection on traded goods to the proportion of the value of intermediate goods in their total value. The basic study was conducted at a level intermediate between the three and four digit levels.

4. Measures of protection are not, in themselves, very useful, since high rates of effective protection can either increase the profitability of an activity which is viable in world prices, or make profitable an otherwise unprofitable activity. 3/ Thus, it is desirable to measure the viability of the

1/ M. G. Phelps and B. Wasow, Measuring Protection and its Effects in Kenya, Working Paper No. 37, I.D.S., Nairobi, undated.

2/ R. Reimer, Effective Rates of Protection in East Africa, Staff Paper No. 78, I.D.S., Nairobi, July 1970.

3/ This is in partial equilibrium. Assuming perfect competition and free factor mobility, all returns are equated, and the effects of protection are mainly on the allocation of resources. Factor returns will be affected in accordance with the Stolper-Samuelson theorem.

various activities, as well as the effective protection accorded them, and then to compare the two. The protective system is more "inefficient" the higher the negative correlation between viability and protection.

5. The Phelps and Wasow study uses several measures of viability. The first, in line with the Heckscher-Ohlin theory, was factor proportions. In fact, two measures were employed, namely a capital-unskilled labor ratio, and a skilled labor-unskilled labor ratio. These performed very badly. The second measure of viability is the "world price profitability". 1/ The final measure is the "world price rate of return to factor inputs," which measures the ratio of world value added to the social cost of employing the factors making up value added. 2/

6. There are various possible criticisms of these measures. The most important is that, since, in general equilibrium, the return to factors will not exceed their market opportunity costs (i.e., factor returns will be equated throughout the economy), measures of viability must use the correct shadow prices (i.e., market clearing prices of all factors in free trade, assuming perfect factor markets). Since the effect of protection is to change relative factor prices, the shadow prices of some will be higher than the current market price and vice versa. Thus, a general equilibrium model is a necessary condition for deriving shadow prices to be used in evaluating the viability of any given activity. Such a model is not available, of course. In Kenya, derivation of shadow prices is made more difficult by the fact that the factor markets are, in any case, highly imperfect. Thus, estimation of

1/ This is defined as:

$$WPR = \frac{WVA - WuLu - WsLs - R - D}{K}$$

where: WPR = world price profitability
WVA = world value added
Wu = wage rate (unskilled) Lu = employment (unskilled)
Ws = wage rate (skilled) Ls = employment (skilled)
R = rent D = depreciation K = capital stock

2/ This is defined as:

$$WRR = \frac{WVA}{WuLu + WsLs + Kr}$$

where: r = shadow rate of return to capital.

This measure is identical to the Domestic Resource Cost Ratio, except that non-tradeables are removed from the resource cost, an exchange rate is built in, and foreign ownership of capital is ignored.

free trade equilibrium factor prices depends on knowing both the effects of the protective system and the independent effect of market distortions. 1/

7. In measuring protection, or "resource pull", the study also employs various measures. The nominal rate of protection is derived, using the ratio of the domestic price to the world price. Two measures of effective protection are employed, one of which measures the percentage increase in value added permitted by protection, and the other the proportion of domestic value added generated by protection. 2/ The study relies largely on the latter because its denominator is more stable and usually is significantly greater than zero. The world value added is frequently very close to zero. Both of these measures suffer from the same disadvantage of not being able to cope with negative world value added. (For instance, if DVA is increased in such an activity, EPU declines!) The final measures are concerned with the effects of protection on factor returns. One of them concentrates on increased profits as the variable determining resource "pull," and the other is concerned with returns to all primary factors. 3/

8. Some results at the three-digit level are reported in Table 15. The overall conclusion is summarized in the Table below. Essentially it shows a consistent and highly significant negative correlation between measures of protection and viability. For instance, the correlation between the effective rate of protection and world price profitability is -0.65.

9. Before considering overall objections to the use of these measures in analysis of trade policy, certain qualifications have to be made, which, although general in scope, are of great specific importance to the interpretation of this study. First, the figures were derived from firms whose output does not include all outputs under an ISIC Code. Thus, the world price

1/ Other standard objections (such as the assumed restrictions on the production function) are elaborated upon in the paper (op. cit., p. 10).

2/ These are: $EPZ = \frac{DVA - WVA}{WVA} \cdot 100$, and $EPU = \frac{DVA - WVA}{DVA} \cdot 100$

where DVA = Domestic Value Added

3/ The first measure is defined as: $CHP = \frac{DVA - WVA}{K}$, which assumes all increments in value added accrue to profits. Alternative formulations are:

$$CHP^* = EPZ \cdot WPR \text{ and } CHP^{**} = EPU \cdot DPR$$

both of which assume profits receive only a proportionate share in increments in value added.

The second measure is defined as: $CRR = \frac{DVA - WVA}{rK + WuLu + WsLs}$

profitability of ISIC Code No. 311--basic industrial chemicals-- does not mean all industrial chemicals are viable, and vice versa for industries found to be non-viable. Second, the data are now five years out of date. Third, because of uncertainties about appropriate shadow prices, especially of foreign exchange, individual measures of the level of viability are dubious. This is even more true when the theoretical problem of substitution is taken into account. Fourth, as has been noted, the results for agricultural processing industries are very strange, since a large number are shown to be non-viable. Certain problems with the methodology have surfaced here: where the domestic price has been deflated by the tariff, the world price this estimated is sometimes an underestimate of the "true" world price, since, in some cases, the tariff is "redundant", and the domestic price is below the world price with the tariff. Moreover, sometimes, when an industry exports part of its output, the entire value of output has been deflated by the tariff, and not merely the part sold domestically. These practices lead to overstatement of protection and understatement of viability. Finally, one cannot infer from the rankings what the effect on resource allocation has actually been. This depends on all relevant elasticities. It is perfectly possible that the apparent inefficiency of the protective system has led to quite inconsiderable misallocation of resources. Such a hypothesis is lent credence by the low correlation between protection and labor intensity. For these various reasons the study cannot do more than give prima facie justification for the hypotheses that the protective system is inefficient and that this has led to serious misallocation. In particular, although it is at least likely that industries viable in the protected situation will also be viable in free trade, the reverse is not true. Industries that are non-viable, according to the study, could well be viable in free trade, assuming possibilities of substitution between value-added and imported materials. Thus, specific conclusions for individual industries are not to be taken very seriously.

THREE DIGIT CORRELATION MATRIX BETWEEN MEASURES OF VIABILITY AND PROTECTION
(All entries significant at 99% confidence level)

		VIABILITY		PROTECTION		
		WORLD PRICE PROFITABILITY	WORLD PRICE RATE OF RETURN TO FACTORS	EFFEC- TIVE RATE	CHANGE IN PROFIT RATE	CHANGE IN RATE OF RETURN TO FACTORS
PROTECTION	NOMINAL RATE	-0.67	-0.67	+0.78	+0.72	+0.87
	EFFECTIVE RATE	-0.65	-0.71		+0.68	+0.88
	CHANGE IN PROFIT RATE	-0.65	-0.56			+0.83
	CHANGE IN RATE OF RETURN TO FACTORS	-0.70	-0.68			
VIABILITY	WORLD PRICE PROFITABILITY		+0.95			

Source: Phelps and Wasow, op cit, Appendix III.

10. As stated, Reimer's study was used to evaluate the effective protection implicit in the transfer tax system. (He used preliminary information from the input-output table, which was itself based on the 1967 Census of Industrial Production.) Transfer taxes may be imposed by a state if it is in deficit in its trade in manufactured goods with a partner. This tax may not exceed 50 percent of the common external duty. 1/ 2/ Table 19 shows that the effects of the tax are considerable. Tanzanian taxes against Kenyan manufactures produce effective rates of protection (EPZ), which rise to 379.3 percent, and eight are over 100 percent. More striking still is the fact that in ten out of twenty industry groups Kenyan exports to its partners are taxed relative to the outside world (using the 'modified' method).

The Value of the Studies of Effective Protection

11. For reasons already outlined above, both the measures employed, and the theoretical justifications for their use, are dubious. The assumptions required for measurement of effective protection to be precise and meaningful are rather restrictive--in particular, input-output coefficients must be fixed. Furthermore, the tariff structure can tell one nothing about resource allocation. Among, let us say, fifteen activities ranked by effective protection it is perfectly possible for resources to flow out of the second but into the fifth. Finally, in deriving measures of viability, it is extremely important, and very difficult, to have the "right" prices of primary factors.

12. For these reasons, interpretation must be cautious. A situation of the type discussed above is only a good prima facie case for inefficiency. However, various country studies indicate the concepts are practically useful

1/ Details of the system are discussed in "Industrial Development in East Africa: Progress, Policies, Problems, and Prospects" op cit Volume I, p. 5.

2/ The economic implications of the transfer tax system are discussed in P. A. Diamond, Effective Protection in the East African Transfer Taxes, IDS Discussion Paper No. 68. He shows that a partner can be penalized in relation to the outside world if:

$$\frac{\sum a_{ij} t_i}{t_j} > k$$

where i is an input, j is an output, and k is the ratio of the transfer tax to t_j .

when used to explain performance. 1/ Furthermore, at least one study of the general equilibrium aspects of protection supports their usefulness. 2/ Finally, if measured distortions are extreme--if, for example, it is overwhelmingly likely industries would not exist without protection--some greater confidence can be placed in the results.

13. To sum up: we would not like to place excessive trust in individual results, especially in the levels (as opposed to rankings) of effective protection and viability, or in the judgement that certain activities are, in fact, unviable. However, in spite of the many theoretical objections this is an extremely useful tool, whose broad conclusions, when they are as striking as in Kenya, can be used. No more can be reasonably claimed, but no more needs to be claimed either. 3/

1/ See, for example, the OECD series on Brazil, India, Mexico, Pakistan, Taiwan and the Philippines and I. Little, T. Scitovsky, and M. Scott, Industry and Trade in Some Developing Countries, OECD, 1970, which summarizes them.

2/ H. D. Evans, A General Equilibrium Analysis of Protection: The Effects of Protection in Australia (unpublished doctoral dissertation, Harvard University, 1968).

3/ "the qualifications to a theory need not necessarily overwhelm its simple message," M. Corden, The Theory of Protection, Oxford, 1971, p. 243.

APPENDIX 3: PROMOTING FURTHER KENYANIZATION OF THE ECONOMY

1. The Elements of Future Policy. The Mission believes that there are several areas to which the Government might give further attention in formulating its future Kenyanization policy. First, as we have discussed in Volume I the most effective way of achieving a broader impact in Kenyanizing the economy in our view is by making the necessary structural changes in the pattern of growth, both between sectors and within sectors, to favor those kinds of economic activity in which small businesses can most easily be established. But many Kenyans could not take advantage of new economic opportunities, even if they were created, because they lack the means, and sometimes the inspiration, to do so. Another important element of a future strategy therefore relates to the need to broaden and intensify the direct assistance programs designed to reach the smaller farms and businesses.
2. This emphasis on small scale enterprises does not in our view mean that the formal sector should be ignored or abandoned. On the contrary, as we have discussed at length elsewhere in this annex, the formal sector has a vital role to play in the economy. It does mean, however, that the role of the urban formal sector -- and particularly the large foreign controlled segment -- needs to be rather more carefully defined, and reconciled with the goals of Kenyanization.
3. Reaching the Masses. The strategy proposed by this report calls for a relative shift in resource allocation to programs designed to increase production amongst the mass of small scale enterprises, particularly small scale farmers and the majority of African businesses who are to be found in the informal sector. We have proposed this strategy because it is the best way, in our opinion, of making the optimum use of Kenya's source resources and bringing accelerated development to the majority of the population. In particular, we feel that this is the only practicable method of dealing with Kenya's two most troublesome problems -- unemployment and rural poverty -- in the foreseeable future. However, we also firmly believe that a deepening of development -- reaching down to the majority of the working population -- is the most meaningful conception of a policy of Kenyanization, since it can be expected to bring new opportunities for initiative and growth to the mass of potential businessmen and self-employed people where they now are. We are convinced that in the immediate future, the comparative advantage of African entrepreneurs lies in the smaller management unit -- in farming, in trade and in other sectors of the economy. It follows, therefore, that the development of African economic activity can be fostered most efficiently (i.e. with most benefits and least cost) in these sectors than in sectors where the higher demands for capital, experience and managerial ability make entry very much more difficult.
4. This report has therefore endorsed the recommendations of other recent Bank reports, as well as the ILO/UNDP Report, that a larger share of resources be allocated to present and proposed programs to assist small scale African farmers and businessmen. We do not wish to suggest that this can be

done easily, and we have referred to some of the severe constraints, particularly the technology base and absorptive capacity of the critical sectors, which will have to be overcome if a reorientation in the pattern of growth is to be achieved. Moreover, we recognize that it will be especially difficult to reach the lower strata of the income scale, and it is neither possible nor desirable to recommend that the past emphasis on the formal sector of the economy should be replaced by a preoccupation with the informal. We go on to suggest that Kenya's development programs should aim to promote productive activities at all the various levels of the economy.

5. The Stratified Nature of the Economy. In considering future programs for Kenyanizing the economy, it is first necessary to understand the nature of the economy. We believe that economic activity in Kenya covers a wide continuum of enterprises, ranging from the humblest subsistence farm or informal sector activity, at the lowest end of the scale, to large, modern industrial enterprises in the urban formal sector at the other end. In the natural order of things, there is no technological or other line to demarcate "formal sector" activity from "informal sector" activity, only differences in degree between levels of ability, technology, income and wealth. Nor is there any sense in which one level is better or more desirable than the other, since the continuum allows each potential entrepreneur to establish himself at a level suited to his ability and resources, and each level of activity uniquely provides the goods or services consumed by a particular level of household income.

6. The dichotomy between formal and informal activity only emerges when an artificial barrier is put up at some arbitrary point in the spectrum, and discriminating instruments are introduced to impede the development of the smaller businesses. The formal sector barrier in Kenya, which was originally based on foreign concepts of standards and development goals and subsequently entrenched in the law, defines the entry point, or threshold, for legal business activity. Thereafter, Kenya experience has shown that the weight of Government assistance is then applied to propping up the higher echelons of business activity protected by this artificial barrier, and the rest of the economy is actually penalized by the effects of formal sector protection -- and even by legal sanctions and physical harassment.

7. We believe that priority should be given to assembling a strategy for promoting African small scale business activity. There are several components in such a strategy, in our opinion. First, and probably most important, the legality of all legitimate businesses must be firmly established, and the legal impediments to their operation removed. A start has already been made in legalizing matatu taxis, but obviously the process must go further than this. The most characteristic feature of informal sector activities is that they are non-legal (not necessarily illegal, but certainly outside the law). We cannot see how substantial government assistance program can reach businesses which are operating entirely outside the law, and legal recognition must therefore be the first step.

8. Legalization, however, also means recognizing that formal sector

standards -- particularly those applying to the building regulations, labor legislation and health and safety standards -- are simply not relevant to the majority of African businesses or the customers they serve. The second need, therefore, is to confront the whole issue of standards squarely and honestly. We do not feel that a formal sector versus informal sector debate is likely to contribute to the determination of better policy in Kenya. Nor will any real purpose be served by tearing down all the barriers which have been erected to define, promote and protect the formal sector.^{1/} It has to be recognized that the formal sector has a role to play and that a significant and powerful segment of the Kenya population wishes to maintain a relatively high set of standards for formal sector activity, as a standard of excellence and as a long term goal for the economy as a whole. We have no quarrel with this desire, provided that these standards are not used to impede the development of the country as they have in the past.

9. It will be necessary, however, for Kenyanization programs to recognize that the Kenya economy is stratified and that different standards are appropriate at different levels of the economic spectrum. As a first step, the law in all its forms must reflect the diversity of the economy as it is, rather than trying to provide for an ideal society which does not exist. One suggested approach to the problem, first made in an earlier Bank report^{2/}, is for the law to provide for different grades of business in each sector, to reflect the different capabilities of entrepreneurs and the market they wish to supply. Each grade would carry with it its own licensing regulations, wage legislation and so on.^{3/}

10. Thus, at the top, the formal sector would remain as the pinnacle of achievement. It could offer the highest potential rewards to the more successful businessmen, but it would also demand high standards of service, employment practices and accounting procedures, and these standards would severely limit entry, as they now do. Lower down the scale, a "Class B" license would be available for the businessman who has climbed several rungs of the ladder, but cannot make the top. He would have a more limited horizon, serve a lower strata of society, and pay lower wages, but because of these less stringent requirements entry would be easier. Similar gradations could go lower down the business ladder, the number depending upon the nature of the sector. The important

^{1/}

Although we have suggested changes in policy to induce the formal sector to operate to the greater benefit and lower cost of the economy.

^{2/}

See IBRD Report No. AE-22, op. cit., Annex A is para. 52-56.

^{3/}

This does not mean we necessarily endorse any particular form of licensing or regulation of private sector activity. But if Kenya is to continue licensing businesses and laying down minimum standards for the conditions in which they operate, then the licensing and the standards should reflect the real world they are trying to regulate.

point is that the further the ladder is lowered into the business sector, the greater the potential impact of any promotional programs. The businessman who cannot grasp even the lowest rung will continue to be beyond the reach of any assistance.

11. The law should also provide for unrestricted access to all citizens in each category of business. Provided a businessman can satisfy the minimum requirements laid down for a particular class, and pays the prescribed fee, licenses should be readily available. We can see no justification for the general use of licensing, or any other control instrument, to restrict competition among citizens. 1/

12. Once the legislative impediments had been cleared away, the Government could plan for an extension outreach. 2/ The differential licensing system would provide a gradation of entry points (or promotion points) in the continuum of business enterprises. African businessmen would be encouraged to enter the continuum at whatever is their appropriate level, and any particular government extension service could be framed with a specific target community (e.g. Class B traders) in mind. At present, because of the pre-occupation with formal sector standards, the best is often the enemy of the good. For example, there is despondency over the urban informal sector because no one can envisage small backyard activities becoming successful businesses. But this misses the point: a little help (in providing sites, for example) can help to increase output and employment significantly, at very little cost. Again, in agriculture, there is sometimes a reluctance to identify programs which could bring marginal benefits to the rural population because they fail to attain "target" incomes. Yet most people would accept that it is better to achieve £1 million incremental income by raising the incomes of 100,000 households from £20 to £ 30 a year than by raising 10,000 families from £200 to £300 a year.

1/ The Government has now accepted the ILO/UNDP Report's recommendation that the trade licensing should be revised. See "Sessional Paper on Employment", May, 1973, para. 165-71.

2/ A proposal for a small business development program is given in Annex 5.

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Table 1: SHARE OF THE PRIVATE SECTOR IN THE ECONOMY, 1964-72
(percentages)

<u>Year</u>	<u>Percentage Share of Private Sector in:</u>			
	<u>GDP</u>	<u>Value-Added Enterprise Sector /1</u>	<u>Fixed Capital Formation</u>	<u>Modern Sector Employment</u>
1964	76.0	87.3	75.0	68.4
1965	74.7	85.9	74.0	67.7
1966	75.4	86.6	68.4	65.8
1967	75.2	86.6	65.3	64.6
1968	73.5	86.0	63.3	63.4
1969	73.0	85.8	67.3	62.2
1970	72.4	84.8	69.7	61.6
1971	69.1	82.7	64.3	62.3
1972	69.3	83.2	n.a.	61.2

/1 Enterprise Sector = GDP minus General Government.

Source: Annual Statistical Abstracts and Economic Survey 1973.

Table 2: GROSS VALUE ADDED IN THE PRIVATE SECTOR /1 /2, 1964-72,
IN CONSTANT 1964 PRICES
(£ million)

	1964	1965	1966	1967	1968	1969	1970	1971	1972	Compound Annual Growth Rates 1964 - 1972 %
A. Outside Monetary Economy										
Agriculture	73	63	81	84	87	90	93	95	99	3.9
Forestry	2	2	2	2	2	3	3	3	3	4.4
Fishing	0	0	0	0	0	0	0	0	0	3.1
Building and Construction	6	6	6	6	7	7	7	7	7	3.0
Water	2	2	2	2	2	3	3	3	3	3.7
Ownership of Dwellings	6	6	6	6	7	7	8	8	8	5.2
Total	<u>89</u>	<u>77</u>	<u>98</u>	<u>101</u>	<u>105</u>	<u>109</u>	<u>113</u>	<u>116</u>	<u>120</u>	<u>3.8</u>
B. Monetary Economy										
1. Enterprises and Non-Profit Institutions										
Agriculture	52	49	59	58	62	69	72	73	85	6.3
Forestry	1	1	1	1	1	1	2	2	2	9.2
Fishing	1	1	1	1	1	1	1	1	1	3.6
Mining and Quarrying	1	1	2	2	2	2	3	3	2	6.2
Manufacturing and Repairing	29	30	32	35	38	42	45	48	52	7.6
Building and Construction	3	4	5	6	7	7	7	8	8	12.3
Electricity and Water	3	3	4	4	4	5	3	0	0	/3
Transport, Storage and Communications	6	7	8	10	11	10	11	11	11	7.2
Wholesale and Retail Trade	32	34	37	37	40	43	47	51	51	5.8
Banking, Insurance and Real Estate	7	8	9	9	10	11	11	11	13	6.5
Ownership of Dwellings	10	10	10	10	10	11	11	11	11	2.4
Other Services	12	13	15	16	17	18	20	22	26	10.2
Total	<u>158</u>	<u>161</u>	<u>182</u>	<u>189</u>	<u>205</u>	<u>219</u>	<u>232</u>	<u>241</u>	<u>262</u>	<u>6.6</u>
2. Private Households (Domestic Services)	<u>3</u>	<u>3</u>		<u>4</u>	<u>4</u>	<u>3</u>	<u>4</u>	<u>4</u>	<u>4</u>	<u>3.3</u>
Total Monetary Economy	<u>161</u>	<u>164</u>	<u>185</u>	<u>193</u>	<u>208</u>	<u>223</u>	<u>236</u>	<u>245</u>	<u>266</u>	<u>6.5</u>
TOTAL PRIVATE SECTOR VALUE ADDED	<u>249</u>	<u>241</u>	<u>283</u>	<u>294</u>	<u>313</u>	<u>332</u>	<u>349</u>	<u>361</u>	<u>386</u>	<u>5.6</u>

/1 At factor cost.

/2 Errors due to rounding.

/3 Meaningless because of transfer to Public Sector.

/4 Provisional.

Table 3: GROSS VALUE ADDED IN THE PRIVATE SECTOR /1 /2, 1964-72
(£ million)

	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972 /3</u>
A. Outside Monetary Economy									
Agriculture	73	64	82	85	85	89	92	97	111
Forestry	2	2	2	3	3	3	3	4	4
Fishing	0	0	0	0	0	0	0	0	0
Building and Construction	6	6	7	8	9	9	10	10	10
Water	2	2	2	3	3	4	4	4	5
Ownership of Dwellings	6	6	7	8	9	10	10	11	12
Total	<u>89</u>	<u>80</u>	<u>102</u>	<u>107</u>	<u>109</u>	<u>115</u>	<u>120</u>	<u>127</u>	<u>143</u>
B. Monetary Economy									
1. Enterprises and Non-Profit Institutions									
Agriculture	52	47	56	57	58	63	72	72	90
Forestry	1	1	1	1	1	2	2	3	2
Fishing	1	1	1	1	1	1	1	1	1
Mining and Quarrying	1	1	2	2	2	2	2	3	3
Manufacturing and Repairing	29	31	35	39	43	49	54	58	64
Building and Construction	3	4	5	7	9	9	10	11	13
Electricity and Water	3	3	4	4	5	5	3	0	0
Transport, Storage and Communications	6	7	8	9	10	10	11	11	12
Wholesale and Retail Trade	32	34	38	39	42	45	54	59	62
Banking, Insurance and Real Estate	7	8	8	9	11	11	12	12	14
Ownership of Dwellings	10	10	10	11	11	12	13	14	15
Other Services	<u>12</u>	<u>13</u>	<u>14</u>	<u>15</u>	<u>16</u>	<u>18</u>	<u>20</u>	<u>21</u>	<u>24</u>
Total	<u>158</u>	<u>160</u>	<u>183</u>	<u>195</u>	<u>210</u>	<u>228</u>	<u>255</u>	<u>266</u>	<u>300</u>
2. Private Households (Domestic Services)	3	3	4	4	4	4	4	5	5
Total Monetary Economy	<u>161</u>	<u>164</u>	<u>187</u>	<u>199</u>	<u>214</u>	<u>232</u>	<u>258</u>	<u>271</u>	<u>305</u>
TOTAL PRIVATE SECTOR GROSS VALUE ADDED	<u>249</u>	<u>244</u>	<u>288</u>	<u>306</u>	<u>323</u>	<u>347</u>	<u>378</u>	<u>398</u>	<u>448</u>

/1 At factor cost and current prices.

/2 Errors due to rounding.

/3 Provisional.

Source: Annual Statistical Abstracts and Economic Survey for 1973.

Table 4: PRIVATE GROSS VALUE ADDED AS A PERCENTAGE OF TOTAL GROSS VALUE ADDED /1, 1964-72, BY INDUSTRY

	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>
A. Non-Monetary Economy	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
B. Monetary Economy									
1. Enterprises and Non-Profit Institutions									
Agriculture	100.2	100.4	100.2	100.5	99.7	99.2	98.9	98.7	98.7
Forestry	46.8	43.9	46.1	46.2	42.4	53.1	57.9	62.0	58.1
Fishing	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Mining and Quarrying	100.0	100.0	100.0	100.0	100.0	100.0	100.0	96.5	96.6
Manufacturing and Repairing	84.5	84.0	85.1	86.3	86.2	86.8	86.3	81.6	82.0
Building and Construction	47.2	53.2	55.5	59.1	62.8	58.9	59.5	58.2	57.6
Electricity and Water	66.9	66.2	68.2	67.1	73.6	74.0	36.0	0.1	0.2
Transport, Storage and Communications	26.2	24.9	25.7	28.6	28.7	26.2	26.5	26.0	26.5
Wholesale and Retail Trade	98.8	98.0	97.2	97.3	95.9	96.8	97.1	96.3	96.1
Banking, Insurance and Real Estate	71.6	69.1	70.1	68.7	67.8	62.5	57.8	51.3	51.0
Ownership of Dwellings	71.5	71.8	72.7	73.5	74.9	76.6	75.4	75.9	76.3
Other Services	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>99.4</u>	<u>98.9</u>	<u>99.0</u>	<u>98.6</u>	<u>98.0</u>
Total	<u>81.2</u>	<u>79.9</u>	<u>80.4</u>	<u>80.6</u>	<u>80.0</u>	<u>79.9</u>	<u>79.0</u>	<u>76.2</u>	<u>76.9</u>
2. Private Households (Domestic Services)	<u>100.0</u>	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total Private Value Added as a Percentage of GDP	<u>76.0</u>	<u>74.7</u>	<u>75.4</u>	<u>75.2</u>	<u>73.5</u>	<u>73.0</u>	<u>72.4</u>	<u>69.1</u>	<u>69.3</u>

/1 At factor cost and current prices.

/2 Provisional

Source: Annual Statistical Abstracts and Economic Survey for 1973.

Table 5: FIXED CAPITAL FORMATION BY INDUSTRY, 1964-72
(Percentages)

	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u> /1
Outside Monetary Economy	11.8	12.5	10.6	9.1	9.3	9.3	8.2	6.9	6.6
Monetary Economy									
1. Enterprises and Non-Profit Institutions									
Agriculture	15.3	15.2	14.8	11.4	11.9	11.5	11.0	10.4	9.7
Forestry	0.5	0.2	0.5	0.4	0.3	0.2	0.2	0.3	0.2
Mining and Quarrying	0.6	0.7	1.1	0.7	0.5	0.7	1.1	0.8	1.4
Manufacturing and Repairing	13.1	14.5	13.2	12.1	13.6	10.1	11.5	12.6	17.9
Building and Construction	4.3	5.2	4.6	4.9	4.3	4.4	6.2	5.6	4.6
Electricity and Water	3.0	4.2	4.2	7.7	4.0	4.1	3.3	6.0	7.1
Transport, Storage and Communications	23.1	16.2	21.3	19.9	18.5	17.8	17.6	15.1	13.0
Wholesale and Retail Trade	6.8	5.3	4.7	4.5	4.8	4.4	3.9	3.8	3.5
Banking, Insurance and Real Estate	1.6	0.9	0.5	0.9	1.1	0.8	1.6	1.0	1.3
Ownership of Dwellings	4.9	4.7	4.9	6.4	7.8	8.4	8.7	9.4	9.3
Other Services	<u>5.2</u>	<u>5.1</u>	<u>5.3</u>	<u>6.2</u>	<u>6.6</u>	<u>9.1</u>	<u>7.4</u>	<u>6.7</u>	<u>5.6</u>
Total	<u>78.4</u>	<u>72.2</u>	<u>75.1</u>	<u>75.1</u>	<u>73.4</u>	<u>71.5</u>	<u>72.5</u>	<u>71.7</u>	<u>73.6</u>
of which									
Private	63.2	61.5	58.0	56.0	53.9	58.0	61.6	57.3	54.9
Public	15.2	10.7	17.1	19.1	19.5	13.5	10.9	14.4	18.7
2. General Government	9.8	15.3	14.5	15.6	17.2	19.2	19.4	21.3	19.8
TOTAL	<u>100.0</u>	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
of which									
Private	75.0	74.0	68.4	65.3	63.3	67.3	69.7	64.3	61.5
Public	25.0	26.0	31.6	34.7	36.7	32.7	30.3	35.7	38.5

/1 Provisional

Source: Annual Statistical Abstracts and Economic Survey for 1973.

Table 6: FIXED CAPITAL FORMATION IN THE PRIVATE SECTOR, 1967-71
(£ million)

	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>
A. Outside Monetary Economy.					
Traditional Dwellings	7.52	8.37	8.72	9.24	9.74
B. Monetary Economy.					
Enterprises and Non-Profit Institutions					
Agriculture	9.37	10.36	9.92	11.59	14.13
Forestry	-	-	-	-	-
Mining and Quarrying	0.58	0.49	0.64	1.28	1.19
Manufacturing and Repairing	7.42	8.64	9.15	12.85	17.62
Building and Construction	3.41	2.90	2.98	6.01	7.48
Electricity and Water	5.25	2.48	2.87	2.57	3.13
Transport, Storage and Communications	9.35	9.01	10.25	11.91	15.53
Wholesale and Retail Trade	3.70	3.86	3.89	4.17	5.01
Banking, Insurance and Real Estate	0.76	0.97	0.67	1.72	0.89
Ownership of Dwellings	3.32	2.76	4.24	6.39	6.57
Other Services	5.07	5.94	8.45	8.13	9.25
Total /2	<u>48.23</u>	<u>47.41</u>	<u>53.06</u>	<u>66.62</u>	<u>80.80</u>
C. TOTAL PRIVATE SECTOR CAPITAL FORMATION	<u>55.75</u>	<u>55.78</u>	<u>61.78</u>	<u>75.86</u>	<u>90.54</u>

/1 This table is obtained by subtracting the contribution of the public sector to capital formation in each industry from the total capital formation in that industry. The former are only published as provisional figures each year whereas the latter series are revised and the latest figures have been used (with the exception of 1971 where both sets of figures used are provisional). This may cause some inconsistencies.

/2 The totals shown here are the sum of the individual industry components in this table and may not necessarily agree with those obtained by subtracting the total contribution of the public sector to capital formation from total capital formation in Enterprises and Non-Profit Institutions.

Source: Annual Statistical Abstracts

Table 7: PRIVATE SECTOR CAPITAL FORMATION, BY INDUSTRY, 1967-71
(Percentages)

	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>
A. Outside Monetary Economy.					
Traditional Dwellings	13.5	15.0	14.1	12.2	10.8
B. Monetary Economy.					
Enterprises and Non-Profit Institutions					
Agriculture	16.8	18.6	16.1	15.3	15.6
Forestry	0.0	0.0	0.0	0.0	0.0
Mining and Quarrying	1.0	0.9	1.0	1.7	1.3
Manufacturing and Repairing	13.3	15.5	14.8	16.9	19.4
Building and Construction	6.1	5.2	4.8	7.9	8.3
Electricity and Water	9.4	4.4	4.6	3.4	3.5
Transport, Storage and Communications	16.8	16.2	16.6	15.7	17.1
Wholesale and Retail Trade	6.6	6.9	6.3	5.5	5.5
Banking, Insurance and Real Estate	1.4	1.7	1.1	2.3	1.0
Ownership of Dwellings	6.0	5.0	6.9	8.4	7.3
Other Services	9.1	10.6	13.7	10.7	10.2
Total	-----	-----	-----	-----	-----
C. TOTAL PRIVATE SECTOR CAPITAL FORMATION	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

Source: Table 6.

Table 8: WAGE EMPLOYMENT IN THE PRIVATE MODERN SECTOR, 1964-72
(Percentages)

	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u> ^{/1}	Compound Annual Growth 1964-72
Private Sector										
Agriculture and Forestry	51.4	51.4	48.9	44.8	45.0	45.8	46.2	44.7	45.7	
Mining and Quarrying	0.6	0.6	0.6	0.6	0.8	0.7	0.7	0.7	0.6	
Manufactures and Repairs	12.5	13.2	13.6	14.7	15.1	14.8	15.6	17.0	16.8	
Building and Construction	2.3	2.2	2.7	4.5	4.7	4.2	4.2	5.0	5.4	
Electricity and Water	0.6	0.6	0.7	0.7	0.7	0.6	<u>/2</u>	<u>/2</u>	<u>/2</u>	
Commerce	12.6	11.8	12.0	11.2	10.5	10.7	10.0	10.0	9.2	
Transport and Communications	2.8	3.0	3.6	3.8	4.1	4.1	4.2	3.8	4.2	
Services	<u>17.2</u>	<u>17.1</u>	<u>18.0</u>	<u>19.5</u>	<u>19.1</u>	<u>19.1</u>	<u>19.0</u>	<u>18.7</u>	<u>18.1</u>	
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	
Total Number Employed	393,400	393,800	385,000	385,400	384,500	390,100	397,300	424,000	434,200	1.2

/1 Provisional.

/2 Transferred to Public Sector.

Source: Annual Statistical Abstracts and Economic Survey for 1973.

Table 9: TOTAL WAGE EMPLOYMENT, 1967-71
('000s)

	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>Compound Growth Rate 1967 - 1971</u>
Modern Sector:						
Public	212.1	221.9	237.1	247.2	255.7	4.8
Private	<u>385.4</u>	<u>384.5</u>	<u>390.1</u>	<u>397.3</u>	<u>424.0</u>	<u>2.4</u>
Total	<u>597.5</u>	<u>606.4</u>	<u>627.2</u>	<u>644.5</u>	<u>679.7</u>	<u>3.3</u>
Traditional Sector:						
Small Holdings	365.6	366.4	338.7	329.9	342.3	- 1.7
Rural Non-agricultural Activities	<u>61.9</u>	<u>82.0</u>	<u>81.7</u>	<u>90.0</u>	<u>95.0</u>	<u>11.3</u>
Total	<u>427.5</u>	<u>448.4</u>	<u>420.4</u>	<u>419.9</u>	<u>437.3</u>	<u>0.6</u>
TOTAL	<u>1025.0</u>	<u>1054.8</u>	<u>1047.6</u>	<u>1064.4</u>	<u>1117.0</u>	<u>2.2</u>
Total Private	<u>812.9</u>	<u>832.9</u>	<u>810.5</u>	<u>817.2</u>	<u>861.3</u>	<u>1.4</u>

Source: Economic Surveys 1970-2, Unpublished Data for 1967-9; Annual Statistical Abstracts

Table 10: TOTAL EMPLOYMENT, WAGE AND NON-WAGE, IN 1968, BY SECTOR

	<u>No. of Employees</u> ('000s)	<u>Percentage</u>
<u>Wage Employment</u>	<u>1,054.8 /1</u>	<u>24.5</u>
1. <u>Modern Sector</u>	<u>606.4</u>	<u>14.1</u>
(a) Private Sector	384.5	8.9
(b) Public Sector	221.9	5.2
2. Small-holdings and Settlement Schemes	366.4	8.5
3. Rural Non-agricultural Activities	82.0	1.9
 <u>Non-Wage Employment</u>	 <u>3,243.1</u>	 <u>75.5</u>
1. Self Employment	1,035.6	24.1
2. Family Workers	2,207.5	51.4
 TOTAL EMPLOYMENT	 <u>4,297.9 /2</u>	 <u>100.0</u>

/1 This figure in the Plan Document is 1,056.9

/2 This figure in the Plan Document is 4,300.0

Source: Nairobi Urban Study Group - Nairobi and National Employment: Structure and Growth, 1964-70.

(Data compiled from Economic Survey 1970 and Development Plan 1970 - 1974)

Table 11: ESTIMATES OF EMPLOYMENT BY SECTOR 1969, 1971
('000)

	1969				1971			
	Formal	Informal Employment		Total	Formal	Informal Employment		Total
	Wage Employment	Rural	Urban		Wage Employment	Rural	Urban	
Agriculture, Forestry and Fishing	196	4,168	-	4,364	211	4,436	-	4,647
Mining and Quarrying	3	1	-	4	3	1	-	4
Manufacturing	75	30	15	120	93	32	16	141
Building and Construction	29	1	11	41	35	1	12	48
Electricity and Water	5	-	-	5	5	-	-	5
Transport, Storage and Communication	48	3	1	52	46	3	1	50
Wholesale and Retail Trade	44	96	30	170	47	102	32	181
Services	<u>227</u>	<u>19</u>	<u>39</u>	<u>285</u>	<u>240</u>	<u>20</u>	<u>41</u>	<u>301</u>
TOTAL	627	4,318	96	5,041	680	4,595	102	5,377

Source: Mission Estimates.

Table 12: ESTIMATED SECTORAL INCREMENTAL CAPITAL OUTPUT RATIOS
(Ordinary Least Squares Regression)

		Co-efficient of:		Rate of Growth	\bar{R}^2	D.W.
		Constant	Time			
Non-Monetary Economy	ICOR =	+ 0.82 (2.1)	+0.21 (1.7)	+0.085	0.32	2.9
Monetary Economy						
Agriculture and Forestry	ICOR =	+ 1.28 (3.5)	-0.08 /1 (- 0.7)	+0.0858	0.14	2.6
Mining and Quarrying	ICOR =	+ 0.37 /1 (0.6)	+0.45 (2.4)	+0.1116	0.54	3.6
Manufacturing and Repairing	ICOR =	+ 1.56 (19.9)	-0.07 (- 3.0)	+0.0994	0.67	2.1
Building and Construction	ICOR =	- 0.51 /1 (- 0.50)	+1.27 (4.2)	+0.0520	0.80	1.5
Electricity and Water	ICOR =	+ 8.42 (4.7)	-0.51 /1 (- 0.9)	+0.0673	0.03	1.4
Transport, Storage and Communications	ICOR =	+ 0.60 /1 (1.5)	+0.96 (8.1)	+0.1543	0.94	2.4
Wholesale and Retail Trade	ICOR =	+ 0.12 /1 (1.0)	+0.04 /1 (1.2)	+0.0631	0.09	2.7
Banking, Insurance and Real Estate	ICOR =	- 0.84 (- 3.2)	+0.13 (1.7)	-	0.32	2.9
Ownership of Dwellings	ICOR =	+41.39 (3.8)	-5.78 (- 1.8)	-	0.35	2.1
Other Services	ICOR =	+ 0.35 /1 (1.1)	+0.57 (5.8)	+0.0601	0.89	2.1
Government	ICOR =	+ 1.04 (11.6)	+0.27 (10.1)	+0.0064	0.96	2.7
	ICOR =	+ 1.16 (7.3)	+0.19 (3.9)	+0.0711	0.78	3.4
TOTAL	ICOR =	+ 1.05 (5.0)	+0.21 (3.3)	+0.053	0.71	3.5

KEY: ICOR = Incremental Capital Output Ratio
NICOR = Net Incremental Capital Output Ratio
TIME = Time Trend

NOTE:

- (i) The coefficients on Time and the Constant Term were estimated from an equation of the form: $NICOR = a + b \text{ TIME}$; this equation was substituted in the identity: $ICOR = NICOR + b' \frac{1}{r}$, where b' is the ratio of depreciation to sectoral gross value added, and r is the sectoral growth rate. b' was estimated from data contained in the 1967 Input/Output Table.
- (ii) t ratios are shown in parentheses.

/1 Insignificant

Source: Mission calculations

Table 13: ORDINARY LEAST SQUARES: PRIVATE MODERN SECTOR EMPLOYMENT AND GROSS VALUE ADDED (OUTPUT) BY INDUSTRY, 1965-71

Equations	Co-efficient of:		Log Output	\bar{R}^2	D.W.
	Constant	Time			
<u>Agriculture</u> E/O = a + bT	.00373 (14.97)	-.000213 (- 3.82)		0.69	1.29
<u>Mining</u> E/O = a + bT	.00194 (6.53)	-.000152 (- 2.29)		0.41	2.02
log E = a + b log O (t ratio)	-.681 (- 0.96)		0.215 (2.31)	0.42	2.07
<u>Manufacturing</u> E/O = a + bT	.00177 (30.28)	-.0000618 (- 4.72)		0.78	1.68
log E = a + b log O	-1.617 (- 1.51)		0.538 (5.31)	0.82	1.69
<u>Building</u> log E = a + b log O	-8.534 (- 5.57)		1.288 (7.34)	0.898	2.57
<u>Commerce</u> E/O = a + bT	.00143 (39.10)	-.0000910 (-11.13)		0.95	2.15
log E = a + b log O	6.957 (4.63)		-0.301 (-2.13)	0.37	1.54
<u>Transport</u> E/O = a + bT	.00175 (20.85)	-.0000508 (- 2.71)		0.51	2.13
log E = a + b log O	-2.467 (- 3.16)		0.563 (6.63)	0.88	2.23
<u>Services</u> E/O = a + bT	.00330 (44.33)	-.000141 (- 8.49)		0.92	3.19
log E = a + b log O	1.138 (1.75)		0.310 (4.86)	0.79	2.44
<u>Electricity</u> E/O = a + bT	.000877 (13.29)	-.0000667 (- 3.35)		0.72	2.55
<u>TOTAL</u> E/O = a + bT	.00257 (26.14)	-.000126 (- 5.73)		0.84	1.38
log E = a + b log O	4.411 (4.38)		0.129 (1.55)	0.19	1.14

KEY: E = Employment
T = Time Trend
O = Value Added (K£ '000s)

NOTE:

- (i) Equations with insignificant results have been omitted.
- (ii) t ratios are shown in parentheses.

Source: Mission calculations

Table 14: ORDINARY LEAST SQUARES: MODERN AND TRADITIONAL PRIVATE SECTOR
EMPLOYMENT AND GROSS VALUE ADDED (OUTPUT), 1967-71

		<u>Co-efficient of:</u>		<u>Log Output</u>	<u>\bar{R}^2</u>	<u>D.W.</u>
		<u>Constant</u>	<u>Time</u>			
Agriculture						
(1)	E/O = a + bT (t ratio)	.00933 (20.60)	-.000534 (-3.91)	n.a.	0.78	1.76
Total						
(1)	E/O = a + bT (t ratio)	.00469 (33.28)	-.000225 (-5.28)	n.a.	0.87	1.66

KEY: E = Employment
T = Time Trend
O = Value Added (K£ '000s)

Source: Mission calculations

Table 15: THE PATTERN OF IMPORT SUBSTITUTION /1, 1970
(All Values in E '000s)

ISIC Code		Gross Value Added (V)	Gross Output (Y)	Excise Duty	Output At Market Prices (Y)	Imports C.I.F. (M')	Import Duties (D)	Imports At Market Prices (M)	Community Exports	Non-Community Exports	Total Exports (E)	Total Domestic Supply Z=Y+M-E	V/Y %	D/M' %	M/Z %	E/Z %
CONSUMER GOODS																
201	Meat Products	1,380	7,379	0	7,379	971	101	1,070	388	4,481	4,869	3,580	18.7	10.4	29.9	136.0
202	Dairy Products	1,973	10,019	0	10,019	509	77	585	2,321	333	2,654	7,950	19.7	15.1	7.4	33.4
203	Canned Fruits and Vegetables	352	1,722	0	1,722	293	131	424	270	1,279	1,548	598	20.4	44.7	70.9	258.9
204	Canning and Preservation of Fish	1	69	0	69	288	49	338	0	0	0	406	1.4	17.0	83.3	0.0
205	Grain Mill Products	2,803	16,526	0	16,526	217	43	260	67	1,581	1,648	15,137	17.0	19.8	1.7	10.9'
206	Bakery Products	899	4,398	26	4,424	45	19	63	60	10	70	4,417	20.4	42.2	1.4	1.6
207	Sugar	1,663	6,229	2,828	9,057	1,735	492	2,227	0	125	125	11,160	26.7	28.4	20.0	1.1
208	Sugar Confectionary	84	344	0	344	569	165	734	113	2	115	963	24.4	29.0	76.2	11.9
209	Miscellaneous Foods	1,542	6,235	0	6,235	1,759	279	2,038	1,430	168	1,598	6,675	24.7	15.9	30.5	23.9
211	Spirits	47	159	211	370	271	1,001	1,272	25	10	34	1,608	29.6	369.4	79.1	2.1
212	Wine	0	0	0	0	157	148	304	0	0	0	304	0	94.3	100.0	0.0
213/220	Beer and Malt and Tobacco Manufacturers	6,310	12,008	10,146	22,153	432	344	736	372	38	411	22,478	52.6	87.8 /5	3.3	1.8
214	Mineral Waters	1,374	3,626	506	4,132	28	4	32	86	6	92	4,071	37.9	14.2	0.8	2.2
232	Knitting Mills	628	1,707	0	1,707	1,435	655	2,090	365	26	391	3,406	36.8	45.6	61.4	11.5
234	Spinning, Weaving and Finishing of Textile	1,065	3,381	297	3,678	10,598	3,902	14,500	716	75	791	17,387	31.5	36.8	83.4	4.5
241	Footwear	831	3,115	0	3,115	628	87	715	599	335	933	2,897	26.7	13.9	24.7	32.2
243	Clothing Except Footwear	2,518	8,804	0	8,804	1,810	899	2,709	289	134	423	11,089	28.6	49.7	24.4	3.8
260	Furniture and Fixtures	1,753	4,099	0	4,099	586	150	736	740	46	786	4,049	42.8	25.6	18.2	19.4
280	Printing and Publishing	3,525	7,994	0	7,994	1,274	74	1,348	528	208	736	8,605	44.0	5.8	15.7	8.6
313	Paints	296	1,201	157	1,358	227	53	280	58	35	93	1,545	24.6	23.3	18.1	6.0
315	Soap	1,397	6,079	436	6,515	423	99	522	1,872	26	1,898	5,138	23.0	23.4	10.2	36.9
319	Miscellaneous Chemical Products	1,696	4,764	157	4,921	6,863	431	7,293	2,246	374	2,620	9,504	35.6	6.3	76.0	27.2
	TOTAL	32,136	109,898	14,764	124,621	31,078	9,203	40,276	12,546	9,292	21,835	143,057	29.3	29.6	28.2	15.3
INTERMEDIATE GOODS																
231/233	Cotton Ginning, Cordage, Rope and Twine	688	3,270	0	3,270	1,112	109	1,221	190	259	459	4,033	21.0	9.8	30.3	11.4
244	Made-up Textile Except Clothing	540	2,100	0	2,100	1,408	576	1,985	279	31	311	3,774	25.7	40.9	52.6	8.2
251	Sawn Timber	2,227	5,272	0	5,272	1,049	129	1,179	670	294	963	5,487	42.2	12.3	21.5	17.6
259	Other Wood Products	49	378	0	378	169	9	178	38	301	339	217	13.0	5.3	82.0	156.2
271/272	Manufacture of Pulp Paper and Paperboard	1,175	4,152	0	4,152	6,575	657	7,232	1,319	701	2,020	9,365	28.3	0	77.2	1.6
291	Tanneries and Leather Finishing Plant	322	1,377	0	1,377	331	112	443	321	156	477	1,344	23.4	33.8	33.0	35.5
311	Basic Industrial Chemicals	634	1,269	0	1,269	7,161	92	7,253	273	165	438	8,085	50.0	1.3	89.7	5.4
312	Vegetable and Animal Oils and Fats	125	727	0	727	2,702	208	2,909	403	120	523	3,114	17.2	7.7	93.4	16.8
314	Wattle Bark Extract	392	1,186	0	1,186	0	0	0	4	1,141	1,146	40	33.1	0.0	0.0	2,865.0
316	Pyrethrum Extract	170	1,566	0	1,566	29	9	38	4	2,251	2,256	-652	10.9	31.0	-5.8 /2	-346.0 /2
321	Petroleum Products	2,278	14,324	5,146	19,474	2,791	2,255	5,046	5,816	8,371	14,187	10,329	15.9	80.8	48.9	137.4
332	Glass and Glass Products	501	1,122	0	1,122	664	159	824	163	237	400	1,546	44.7	23.9	53.3	25.2
	TOTAL	9,101	36,743	5,146	41,893	23,991	4,315	28,309	9,315	14,202	23,519	46,682	24.8	18.0	60.6 /3	50.4 /3
CAPITAL GOODS																
300	Rubber Products	519	1,994	0	1,994	2,613	592	3,206	596	21	617	4,583	26.0	22.7	70.0	13.5
331	Clay Products	144	220	0	220	485	82	567	21	0	21	766	65.5	16.9	74.0	2.7
334	Cement	2,886	7,571	0	7,571	30	2	32	1,419	1,645	3,064	4,539	38.1	6.7	0.7	67.5
339	Other Non-Metallic Mineral	308	1,390	0	1,390	593	31	624	20	1	21	1,993	22.2	5.2	31.3	1.1
340	Basic Metal Industries	0	0	0	0	11,850	532	12,382	296	31	327	12,055	0.0	4.5	102.7	2.7
350	Metal Products	4,350	13,131	0	13,131	5,465	532	5,997	1,777	1,045	2,822	16,306	33.1	9.7	36.8	17.3
360	Non-Electrical Machinery	988	2,791	0	2,791	17,077	680	17,756	214	58	272	20,276	35.4	4.0	87.6	1.3
370	Electrical Machinery	3,440	8,260	0	8,260	7,953	859	8,812	1,073	121	1,194	15,877	41.6	10.8	55.5	7.5
381	Ship-building and Repairs	781	1,262	0	1,262	145	0	145	3	0	3	1,404	61.9	0.0	10.2	0.2
383	Motor Vehicle Bodies	1,113	4,030	0	4,030	13,570	4,266	17,836	50	0	50	21,816	27.6	31.4	81.8	0.2
389	Transport Equipment	0	0	0	0	246	33	279	7	0	7	272	0.0	13.4	102.6	2.6
	TOTAL	14,529	40,649	0	40,649	60,027	7,609	67,636	5,476	2,922	8,398	99,887	35.7	12.7 /4	67.7	8.4
	GRAND TOTAL	55,766	187,250	19,910	207,163	115,096	21,127	136,221	27,337	26,416	53,752	289,626	29.8	18.4	47.0	18.6

Note: The allocation of categories is arbitrary in some cases. It follows that employed in Dr. S. Gulsinger's paper Tariffs and Trade Policies for the Ethiopian Manufacturing Sector Annex Table 1.

/1 Errors due to Rounding.

/2 Figures are meaningless because of negative domestic use.

/3 Excluding petroleum products these ratios become 64.0% and 25.7% respectively.

/4 Excluding Motor Vehicle Bodies this ratio would be 7.2%

/5 Negative imports gives meaningless results.

Source: Central Statistical Office Unpublished Data.

Table 16: END USE ANALYSIS OF IMPORTS, 1964-72
(£ million and percentages)

	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>Compound Annual Rate of Growth</u>
Intermediate Goods	43.90 (55.3)	54.79 (58.9)	59.96 (54.2)	59.87 (54.3)	64.52 (55.9)	68.28 (58.0)	82.82 (56.2)	104.45 (56.2)	102.20 (56.1)	11.1
Capital Goods	11.48 (14.5)	11.37 (12.2)	17.15 (15.5)	22.94 (20.8)	19.39 (16.8)	20.22 (17.2)	27.60 (18.7)	36.31 (19.6)	36.25 (19.9)	15.5
Household Consumption Goods	21.64 (27.3)	22.76 (24.4)	26.64 (24.1)	22.29 (20.2)	25.82 (22.4)	24.47 (20.7)	31.35 (21.2)	35.99 (19.4)	35.52 (19.5)	6.4
Government Imports	2.34 (2.9)	4.23 (4.5)	6.83 (6.2)	5.13 (4.7)	5.68 (4.9)	4.86 (4.1)	5.81 (3.9)	8.95 (4.8)	8.20 (4.5)	17.0
TOTAL	79.36 (100.0)	93.15 (100.0)	110.58 (100.0)	110.23 (100.0)	115.40 (100.0)	117.84 (100.0)	147.58 (100.0)	185.70 (100.0)	182.17 (100.0)	10.9

Source: Economic Survey 1970 and 1973.

Table 17: THE STRUCTURE OF EXPORTS, /1/2
(in 1,000 and percentages)

	1964			1968			1970			1972			Compound Growth Total 1964 - 1972
	East African Community	Rest of World	Total										
Non-Processed Foodstuffs													
Meat ^{1/3}	348	820	1,168	326	896	1,222	353	1,035	1,388	234	1,642	1,876	6.1
Mutton, Mutton	(1.1)	(1.7)	(1.6)	(1.2)	(1.6)	(1.5)	(1.1)	(1.4)	(1.3)	(0.7)	(1.8)	(1.5)	...
Meat, Hmilled	0	17	17	23	4,774	4,797	0	4	4	478	1	1	(0.4)
Wheat and Spelt, Unmilled ^{1/4}	(0.0)	(0.0)	(0.0)	(0.1)	(8.3)	(5.7)	(0.0)	(0.0)	(0.0)	(1.3)	(0.0)	(0.0)	7.3
Fruit and Vegetables	964	0	964	1,578	0	1,578	1,363	0	1,363	1,692	0	1,692	(1.6)
Coffee	(3.7)	(0.0)	(1.3)	(6.0)	(0.0)	(1.9)	(4.3)	(0.0)	(1.3)	(1.4)	(0.0)	(1.4)	14.6
Tea	(1.8)	1,189	1,668	(2.7)	2,228	2,960	854	(2.7)	3,221	(4.1)	(2.7)	(4.0)	6.0
Tobacco	(0.1)	15,399	15,400	(0.1)	12,825	12,825	(0.0)	22,259	22,270	85	(21.6)	24,861	(20.2)
Tannin	(0.1)	13,299	13,300	(0.1)	12,209	12,210	(0.0)	(15.2)	(15.2)	(0.3)	(31.1)	(30.8)	12.5
Tannin	370	6,056	6,426	346	10,541	10,887	478	12,704	13,182	68	16,417	16,485	(13.4)
Tannin	(1.4)	(12.9)	(8.8)	(1.3)	(17.4)	(12.3)	(1.5)	(17.2)	(12.8)	(0.2)	(18.1)	(13.4)	...
Total	2,195	23,478	25,673	3,013	30,757	33,770	3,059	39,253	42,312	3,705	46,635	50,340	8.8
Timed Meat ^{1/3}	(8.5)	(49.8)	(35.2)	(11.4)	(53.2)	(40.1)	(9.7)	(54.8)	(41.1)	(11.3)	(51.4)	(40.8)	...
Pineapples, Timed ^{1/6}	0	1,247	1,247	0	2,130	2,130	0	1,818	1,818	113	3,234	3,347	12.0
Beverages and Tobacco	(0.0)	(2.9)	(1.8)	(0.0)	(3.7)	(2.5)	(0.0)	(2.5)	(1.8)	(0.3)	(3.6)	(2.7)	0.7
Pineapples, Unmilled ^{1/6}	0	874	874	0	439	439	0	669	669	3	920	923	(0.3)
Beverages and Tobacco	(0.0)	(1.9)	(1.2)	(0.0)	(0.8)	(0.5)	(0.0)	(0.9)	(0.6)	(0.4)	(1.0)	(0.7)	(0.3)
Beverages and Tobacco	2,924	0	2,924	4,922	26	518	432	141	573	545	49	594	(0.3)
Beverages and Tobacco	(11.3)	(0.1)	(4.0)	(1.9)	(0.5)	(1.4)	(1.2)	(0.2)	(0.6)	(1.7)	(0.0)	(0.5)	(0.3)
Total	2,924	2,253	5,177	4,922	2,595	3,087	432	2,628	3,060	661	4,203	4,864	(1.0)
Other Foodstuffs ^{1/5}	(11.2)	(4.8)	(7.1)	(7.1)	(7.7)	(4.3)	(1.4)	(3.7)	(3.0)	(2.0)	(4.9)	(3.9)	4.3
Other Foodstuffs ^{1/5}	(14.5)	(3.3)	(7.4)	(8.6)	(2.1)	(4.3)	(14.5)	(3.1)	(7.0)	(15.7)	(2.8)	(6.2)	...
Non-Processed Basic Materials													
Hides and Skins	0	1,294	1,294	0	1,671	1,671	0	1,653	1,653	0	3,777	3,777	14.3
Wool, Raw	(0.0)	(2.7)	(1.8)	(0.0)	(2.9)	(2.0)	(0.0)	(2.2)	(1.4)	(0.0)	(4.2)	(3.1)	(0.3)
Cotton, Raw	0	514	514	0	576	576	0	373	373	0	384	384	(0.3)
Silk Fibre and Tow	(0.0)	(1.1)	(0.7)	(0.0)	(1.0)	(0.7)	(0.0)	(0.5)	(0.3)	(0.0)	(0.4)	(0.3)	(0.3)
Cotton, Raw	0	648	648	0	398	398	0	1,226	1,226	4	1,220	1,224	8.3
Silk Fibre and Tow	(0.0)	(1.4)	(0.9)	(0.0)	(0.9)	(0.5)	(0.0)	(1.7)	(1.1)	(0.0)	(1.3)	(1.0)	(0.3)
Silk Fibre and Tow	(0.0)	6,028	6,028	0	1,832	1,832	0	1,865	1,865	4	2,068	2,072	(13.0)
Silk Fibre and Tow	(0.0)	(12.8)	(8.3)	(0.0)	(3.2)	(2.2)	(0.0)	(2.6)	(1.9)	(0.0)	(2.6)	(1.7)	...
Total	0	8,484	8,484	0	4,477	4,477	0	5,117	5,117	8	7,449	7,457	(1.5)
Processed Basic Materials, Mineral	(0.0)	(18.0)	(11.6)	(0.0)	(7.7)	(5.3)	(0.0)	(7.1)	(5.0)	(0.0)	(8.2)	(6.0)	7.6
Fuels and Lubricants	0	2,167	2,167	0	2,504	2,504	0	1,748	1,748	12	3,890	3,902	(3.2)
Fuels and Lubricants	(0.0)	(4.6)	(3.0)	(0.0)	(4.3)	(3.0)	(0.0)	(2.4)	(1.6)	(0.0)	(2.4)	(1.7)	(3.2)
Fuels and Lubricants	2,512	2,160	4,672	4,409	6,261	10,670	5,600	8,176	13,776	8,172	11,282	19,454	19.5
Fuels and Lubricants	(9.7)	(8.4)	(6.4)	(16.7)	(10.8)	(12.1)	(17.8)	(11.9)	(13.4)	(24.9)	(12.5)	(15.8)	...
Total	2,512	4,227	6,839	4,409	8,765	13,174	5,600	9,924	15,524	8,184	15,172	23,356	16.5
Other Basic Materials, Mineral	(3.2)	(9.2)	(9.4)	(16.7)	(15.2)	(15.7)	(17.8)	(13.9)	(15.1)	(25.0)	(16.7)	(18.9)	...
Fuels and Lubricants	396	2,166	2,562	1,230	2,404	3,634	1,307	2,958	4,265	840	3,265	4,105	6.0
Fuels and Lubricants	(1.5)	(4.6)	(3.5)	(4.7)	(4.2)	(4.3)	(4.2)	(4.1)	(4.1)	(2.6)	(3.6)	(3.3)	...
Manufactured Goods													
Chemicals	3,026	1,845	4,871	3,855	2,823	6,678	4,850	3,523	8,373	5,224	4,772	9,996	9.4
Rubber Goods ^{1/4}	(11.7)	(3.9)	(6.7)	(14.6)	(4.9)	(7.9)	(15.4)	(4.9)	(8.1)	(15.9)	(5.3)	(8.1)	...
Paper, Paperboard and Manufactures ^{1/4}	281	0	281	232	0	232	287	0	287	371	12	383	3.9
Leather	(1.1)	(0.0)	(0.4)	(0.9)	(0.0)	(0.3)	(0.9)	(0.0)	(0.3)	(1.1)	(0.0)	(0.3)	(0.3)
Textile ^{1/7}	866	0	866	1,537	0	1,537	1,485	0	1,485	1,491	983	2,474	14.0
Cement	(3.3)	(0.0)	(1.2)	(5.8)	(0.0)	(1.8)	(4.7)	(0.0)	(1.4)	(5.5)	(1.1)	(2.0)	11.2
Glassware	0	189	189	0	149	149	0	189	189	106	336	442	8.7
Metal Manufactures	(0.0)	(0.4)	(0.3)	(0.0)	(0.2)	(0.2)	(0.0)	(0.3)	(0.2)	(0.2)	(0.2)	(0.2)	...
Metal Manufactures	665	188	853	1,001	350	1,351	1,008	308	1,316	1,233	404	1,637	11.6
Metal Manufactures	(2.6)	(0.8)	(1.4)	(3.8)	(1.2)	(2.6)	(4.4)	(0.8)	(3.0)	(5.4)	(1.8)	(3.6)	6.4
Metal Manufactures	953	805	1,758	990	1,172	2,162	1,419	1,644	3,063	798	1,964	2,762	...
Metal Manufactures	(4.0)	(2.7)	(3.3)	(3.8)	(2.6)	(2.6)	(4.5)	(2.3)	(3.0)	(2.4)	(2.2)	(2.2)	...
Metal Manufactures	1,000	402	1,402	88	0	88	298	0	298	233	46	279	(18.0)
Metal Manufactures	(3.9)	(0.9)	(1.9)	(0.3)	(0.0)	(0.1)	(0.9)	(0.0)	(0.3)	(0.7)	(0.1)	(0.2)	...
Metal Manufactures	1,616	377	1,993	1,372	567	1,939	1,688	401	2,087	2,235	795	3,030	5.4
Metal Manufactures	(6.2)	(0.8)	(2.7)	(5.2)	(1.0)	(2.3)	(5.4)	(0.6)	(2.0)	(6.8)	(2.0)	(2.5)	...
Metal Manufactures	1,943	0	1,943	975	0	975	615	0	615	336	201	537	(15.0)
Footwear ^{1/4}	(7.5)	(0.0)	(3.7)	(2.7)	(0.0)	(1.2)	(2.0)	(0.0)	(0.6)	(1.0)	(0.2)	(0.4)	...
Footwear	1,398	77	1,475	686	398	1,084	574	326	900	489	262	751	(8.5)
Footwear	(5.4)	(0.2)	(2.0)	(2.6)	(0.7)	(1.3)	(1.8)	(0.5)	(0.9)	(1.5)	(0.3)	(0.6)	...
Footwear	2,086	651	2,737	4,925	1,238	6,163	5,171	2,298	7,469	1,534	1,180	2,714	0.0
Footwear	(8.1)	(1.4)	(3.7)	(18.7)	(2.1)	(7.3)	(16.4)	(3.2)	(7.2)	(4.7)	(1.3)	(2.2)	...
Total	13,869	4,591	18,460	14,916	6,835	21,751	16,481	8,926	25,407	14,249	11,174	25,423	4.1
Miscellaneous	(33.6)	(9.7)	(25.3)	(36.6)	(11.8)	(25.9)	(37.4)	(12.3)	(26.7)	(43.5)	(12.3)	(20.6)	(2.0)
Miscellaneous	122	245	367	8	403	411	0	128	128	1	189	190	...
Miscellaneous	(0.5)	(0.5)	(0.3)	(0.0)	(0.7)	(0.3)	(0.0)	(0.2)	(0.1)	(0.0)	(0.2)	(0.2)	...
TOTAL	25,886	42,114	72,000	26,334	52,795	84,129	31,449	71,605	103,054	32,789	90,580	123,379	6.8
	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	...

1/ Excludes re-exports.
 2/ Exports due to re-exports.
 3/ For East exports 'meat preparations' are included with 'Meat'.
 4/ Includes of an incomplete breakdown some domestic exports under these categories may be included under 'Other'.
 5/ All items other than those specifically mentioned.
 6/ For East exports 'Timed pineapples' are included with 'Fruit and Vegetables'.
 7/ Includes textile yarns, fabrics, made-up textiles, cotton piece goods, rival bags and sacks, and bismale.
 8/ Source: Annual Statistical Abstracts, East African Customs and Excise Department Annual Trade Reports of Tanzania, Uganda, and Kenya 1972.

Table 18: THE STRUCTURE OF EXPORTS, 1964 AND 1972
(Percentages)

	1964			1972		
	<u>To EAC</u>	<u>To Rest of World</u>	<u>Total</u>	<u>To EAC</u>	<u>To Rest of World</u>	<u>Total</u>
Non Processed Foodstuffs	8.5	91.5	100.0	7.4	92.6	100.0
Processed Foodstuffs	56.4	43.6	100.0	13.6	86.4	100.0
Other Foodstuffs	71.1	28.9	100.0	67.2	32.8	100.0
Non Processed Basic Materials	0.0	100.0	100.0	0.1	99.9	100.0
Processed Basic Materials	36.7	63.3	100.0	35.0	65.0	100.0
Other Basic Materials	15.5	84.5	100.0	20.5	79.5	100.0
Manufactures	75.1	24.9	100.0	56.1	43.9	100.0
Miscellaneous	<u>33.2</u>	<u>66.8</u>	<u>100.0</u>	<u>1.0</u>	<u>99.0</u>	<u>100.0</u>
TOTAL	<u>35.5</u>	<u>64.5</u>	<u>100.0</u>	<u>26.6</u>	<u>73.4</u>	<u>100.0</u>

Source: Table 17.

Table 19: THE EFFECTIVE RATE OF PROTECTION OF THE EAST AFRICAN TRANSFER TAX

	Transfer Tax Levied by Tanzania on Kenya		Transfer Tax Levied by Uganda on Kenya		Effective Protection Afforded to Kenya	
	Effective Rate	Nominal Rate	Effective Rate	Nominal Rate	"Modified"/ ¹ Method	Balassa Method
Dairy Products	6.2	0.8	-	-	92.8	123.6
Canning and Preserving of Fruit and Vegetables	18.5	2.8	5.5	0.9	30.9	59.8
Bakery Products, incl. Cocoa, Chocolate and Sugar Confectionery	171.1	17.5	-	-	183.8	275.0
Sugar Factories and Refineries	379.3	24.6	-	-	62.9	104.2
Beer	63.6	25.0	-	-	- 24.2	- 20.5
Tobacco	309.7	50.0	-	-	- 10.6	- 9.0
Spinning, Weaving, Printing and Dyeing	115.6	19.2	-	-	73.6	96.1
Cordage, Rope and Twine	-	-	0.8	0.3	28.3	33.1
Blanket Manufacturing	-	-	17.3	4.6	- 23.5	- 22.6
Garment Making and Knitting	101.2	20.0	40.7	10.6	- 32.1	- 30.9
Made-up Textiles Except Clothing	69.2	13.8	-	-	- 50.3	- 49.4
Footwear	115.9	15.0	68.8	11.0	- 12.8	- 10.1
Pulp, Paper, and Paper Board and Manufactures thereof	34.8	7.3	43.0	8.6	- 19.4	- 16.9
Rubber Products	28.0	7.7	-	-	51.9	61.8
Paints, Varnishes, and Lacquers	110.7	18.0	45.7	10.0	- 4.7	10.0
Soap	140.4	18.1	-	-	0.5	12.2
Other Chemicals	39.1	7.2	-	-	- 11.5	- 8.1
Cement	-	-	12.2	4.7	9.7	23.1
Metal Products	29.4	6.7	16.6	4.1	- 15.9	- 13.5
Misc. Manufacturing	0.8	0.3	6.4	2.2	70.9	78.3

¹ The "modified" method assumes the prices of non-traded goods are raised in proportion to the average tariff.

Source: R. Reimer Op. Cit. Table 2.

Table 20: IMPORT IMPLICATIONS OF SECTORAL INCREMENTS
IN GROSS VALUE ADDED, 1967
(per £ 1,000)

	£
A. <u>NON-MONETARY SECTOR</u>	
1. Agriculture, Fishing and Forestry	6.2
2. Building and Construction, Water Collection and Ownership of Dwellings	47.8
B. <u>MONETARY SECTOR</u>	
3. Agriculture, Fishing and Forestry	157.5
4. Prospecting, Mining and Quarrying	274.5
5. Food Manufacturing excluding Bakeries	213.8
6. Bakery Products including Cocoa and Chocolate Products	255.9
7. Beverages and Tobacco Manufacturing	153.2
8. Textile Raw Materials (cotton ginning, cordage, rope and twine)	288.0
9. Finishing Textiles (spinning, weaving, blanket manufacturing, printing and dyeing)	807.1
10. Knitting, Garment Making and Made-up Textiles	969.6
11. Footwear, Leather and Fur Products	744.8
12. Sawmilling	180.1
13. Wood Products, Printing and Publishing	683.0
14. Rubber Products	629.5
15. Paints, Varnishes and Soaps	667.4
16. Petroleum Products and Other Chemicals	840.3
17. Cement, Pottery and Miscellaneous Non-Metallic Minerals	311.4
18. Basic Metal Products, Machinery and Miscellaneous Manufacturing	796.9
19. Manufacturing, Building and Repair of Transport Equipment	496.2
20. Electricity and Water	189.2
21. Building and Construction	475.7
22. Distribution	149.0
23. Transport and Communications	258.8
24. Restaurants and Hotels	245.8
25. Ownership of Dwellings	38.0
26. Financial Institutions	62.2
27. Business Services, Personal Services, Recreation and Non-Business Services	207.8
28. Education, Health, Government Administration and Defense	120.8
29. Ownership of Business Premises	0.0
30. Unspecified	0.0

Note: Includes direct and indirect import effects.

Source: Extracted from the Input/Output Table for Kenya, 1967.

Table 21: AVERAGE EARNINGS IN MODERN PRIVATE SECTOR, 1964-72
Indices (1964 = 100)

	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u> /1
Agriculture and Forestry	100	105.7	112.6	111.0	115.9	119.1	122.1	130.8	153.0
Mining and Quarrying	100	92.0	136.7	163.2	139.8	189.2	196.3	202.3	147.6
Manufacturing	100	99.7	119.1	122.9	134.7	140.3	151.1	147.9	157.9
Construction	100	100.6	134.0	119.5	131.0	162.6	171.6	168.7	176.9
Electricity, Gas, Water, etc.	100	112.6	118.2	132.3	135.1	184.4	-	-	-
Commerce	100	111.6	118.5	133.7	141.3	133.9	155.1	149.5	164.7
Transport, Storage, and Communications	100	103.8	111.9	118.3	124.9	117.6	131.7	132.2	144.7
Services	<u>100</u>	<u>98.8</u>	<u>102.0</u>	<u>99.9</u>	<u>115.8</u>	<u>121.9</u>	<u>134.1</u>	<u>140.1</u>	<u>151.1</u>
TOTAL PRIVATE SECTOR	<u>100</u>	<u>104.1</u>	<u>112.7</u>	<u>124.7</u>	<u>134.3</u>	<u>137.0</u>	<u>146.7</u>	<u>150.2</u>	<u>161.5</u>
TOTAL PUBLIC SECTOR	<u>(100)</u>	<u>(110.4)</u>	<u>(117.2)</u>	<u>(119.6)</u>	<u>(122.4)</u>	<u>(122.4)</u>	<u>(129.7)</u>	<u>(137.3)</u>	<u>(141.4)</u>

/1 Provisional

Source: Annual Enumeration of Employees 1964-1970 (Unpublished data 1968-1970), Economic Survey 1973.

Table 22: HOUSEHOLD INCOME DISTRIBUTION BY ECONOMIC GROUP AND INCOME SIZE, 1968-70

<u>Economic Group</u>	<u>Annual Income</u> K£	<u>Number of</u> <u>Households /1</u> ('000s)
Owners of medium-sized to large non-agricultural enterprises in the formal sector of commerce, industry and services; rentiers; big farmers; self-employed professional people; holders of high-level jobs in the formal sector.	1,000 and over	30
Intermediate-level employees in the formal sector; owners of medium-sized non-agricultural enterprises in the formal sector; less prosperous big farmers.	600 - 1,000	50
Semi-skilled employees in the formal sector; prosperous smallholders; better-off owners of non-agricultural rural enterprises; a small proportion of owners of enterprises in the formal sector.	200 - 600	220
Unskilled employees in the formal non-agricultural sector; significant proportion of smallholders; most of the owners of non-agricultural rural enterprises.	120 - 200	240
Employees in formal-sector agriculture; a small proportion of unskilled employees in the formal sector; better-off wage earners and self-employed persons in the informal urban sector; a small proportion of owners of non-agricultural rural enterprises.	60 - 120	330
Workers employed on small holdings and in rural non-agricultural enterprises; a significant proportion of employed and self-employed persons in the informal urban sector; sizeable number of smallholders.	20 - 60	1,140
Smallholders; pastoralists in semi-arid and arid zones; unemployed and landless persons in both rural and urban areas.	20 and less	330
Total		<u>2,340</u>

/1 Very approximate.

Source: ILO/UNDP Report, op. cit. p. 74.

Table 23: AVERAGE EARNINGS OF URBAN EMPLOYEES, BY OCCUPATIONAL GROUP AND AGE
(Shillings per month)

<u>Occupational Group</u>	<u>Age in Years</u>							
	<u>15-19</u>	<u>20-24</u>	<u>25-29</u>	<u>30-34</u>	<u>35-39</u>	<u>40-44</u>	<u>45-49</u>	<u>50+</u>
Professional, Scientific and Technical	-	-	670	775	1,704	4,292	3,500	4,769
Other Professional	-	-	650	1,109	1,490	1,924	1,238	1,360
Technicians	-	-	551	769	915	1,485	1,886	1,680
Foremen and Supervisors	-	-	335	626	1,176	1,300	2,585	1,288
Administrative, Executive and Managerial	-	-	-	1,045	2,445	4,166	4,877	3,442
Clerical and Sales	-	263	504	581	802	1,199	1,600	1,348
Skilled	-	360	370	409	477	529	646	754
Semi-skilled and Unskilled	53	54	156	242	309	324	324	376
No Answer	-	-	377	425	498	396	393	1,900

Source: IBRD

Table 24: AVERAGE EARNINGS PER EMPLOYEE, 1968-72
(£ per year)

	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u> /1
Private Sector					
Agriculture	71.1	72.7	74.6	79.9	93.5
Mining and Quarrying	241.4	307.7	344.8	355.4	259.3
Manufacturing and Repairs	324.7	341.5	367.0	359.4	383.6
Building and Construction	254.1	312.9	329.4	323.8	339.6
Electricity and Water	518.5	570.3	-	-	-
Commerce	520.0	492.8	572.9	552.2	608.5
Transport, Storage and Communications	398.7	375.0	418.2	419.7	459.6
Services	191.6	201.3	221.8	231.7	249.9
Public Sector	<u>302.4</u>	<u>302.6</u>	<u>320.2</u>	<u>339.0</u>	<u>349.0</u>
TOTAL	<u>241.1</u>	<u>344.9</u>	<u>261.4</u>	<u>271.2</u>	<u>286.9</u>

/1 Provisional

Source: Economic Survey 1972 and 1973.

Table 1: PRINCIPAL INTEREST RATES, 1967-72
(Percentage rates)

	As at June 30						As at
	1967	1968	1969	1970	1971	1972	March 31 1973
CENTRAL BANK OF KENYA							
1. Rediscount Rate for Treasury Bills	n.a.	n.a.	4.50	4.00 ^{/1}	2.00	4.00	3.79
2. Advances Against Treasury Bills	n.a.	n.a.	5.00	4.50 ^{/1}	2.50	4.50	4.29
3. Bills and Notes Under Crop Finance Scheme							
-- Discounts	5.00	5.00	5.00	5.00	5.00	5.00	5.00
-- Advances	6.00	6.00	6.00	6.00	6.00	6.00	6.00
4. Other Bills and Notes							
-- Discounts	5.50	5.50	5.50	5.50	5.50	5.50	5.50
-- Advances	6.50	6.50	6.50	6.50	6.50	6.50	6.50
5. Advances Against Kenya Government Securities	6.50	6.50	6.50	6.50	6.50	6.50	6.50
KENYA COMMERCIAL BANKS: ^{/2}							
1. Deposits							
(i) Time							
(a) Minimum 30 days (7 days' notice)							
-- K Sh 200,000 up to K Sh 500,000	3.00	3.00	3.00	3.00	3.00	3.00	3.00
-- K Sh 500,000 and over	3.25	3.25	3.25	3.25	3.25	3.25	3.13
(b) 3 to less than 6 months	3.50	3.50	3.50	3.50	3.50	3.50	3.50
(c) 6 to less than 9 months	3.75	3.75	3.75	3.75	3.75	3.75	3.75
(d) 9 to less than 18 months -- w.e.f. 1-9-68	4.00	4.00	4.00	4.00	4.00	4.00	4.00
(e) 18 to less than 24 months (minimum K Sh 500,000) -- w.e.f. 1-9-68	...	...	4.50	4.50	4.50	4.50	4.50
(f) Longer periods (minimum K Sh 500,000)	...	...	...	...	...	^{/3}	^{/3}
(ii) Savings	3.00	3.00	3.00	3.00	3.00	3.00	3.00
2. Loans and Advances (minimum)	7.00	7.00	7.00	7.00	7.00	7.00	7.00
OTHER FINANCIAL INSTITUTIONS:							
1. Kenya Post Office Savings Bank							
-- Deposits	2.50	3.00 ^{/4}	3.00	3.00	3.00	3.00	3.00
2. Agricultural Finance Corporation							
-- Loans	7.50 ^{/5}	7.50 ^{/5}	7.50	7.50	7.50	7.50	7.50
3. Hire Purchase Companies							
-- Deposits (various periods)	...	3.00- 6.00	3.00- 6.00	3.00- 6.00	3.00- 6.00	3.00- 6.00	3.00- 7.50
-- Loans	...	10.00-12.00	10.00-12.00	10.00-12.00	10.00-12.00	10.00-12.00	7.00-12.00
4. Building Societies ^{/6}							
-- Deposits (various periods)	...	4.00- 6.50	4.00- 6.50	4.00- 6.50	4.50- 7.00	4.50- 7.00	5.50- 6.50
-- Loans	...	7.50-10.00	7.50-10.00	7.50-10.00	7.50-10.00	7.50-10.00	7.50-10.00

... indicate data not available.

^{/1} Val'd until April, 1970, when the balance of Treasury Bills outstanding was redeemed by the Treasury.

^{/2} In Kenya, banks collectively agree on the rates they grant or charge on deposits and loans respectively.

^{/3} Individual Banks free to determine rate.

^{/4} w.e.f. July 1, 1968.

^{/5} Includes Land and Agricultural Bank of Kenya.

^{/6} Includes Institutions not registered under the Building Societies Act, but whose primary function is to finance the purchase of property.

Source: Central Bank of Kenya Annual Report for the Years Ending 30th June, and Economic and Financial Review Quarterly Vol. V - No. 3 - January-March, 1973.

Table 26: ORDINARY LEAST SQUARES: PRIVATE MODERN SECTOR PRODUCTIVITY PER HEAD AND AVERAGE WAGES, 1964-70

$$\log \frac{V}{E} = a + b \log W$$

	<u>Industry</u>	<u>Constant</u>	<u>Log Wages</u>	<u>R²</u>	<u>D.W.</u>
(1)	Manufacturing (t ratio)	7.766 (57.17)	0.988 (8.90)	0.93	1.51
(2)	Commerce (t ratio)	8.060 (55.27)	1.627 (8.65)	0.92	1.36
(3)	Other Services (t ratio)	6.888 (27.78)	0.905 (6.25)	0.86	1.27
(4)	Total Private Modern Sector (t ratio)	8.286 (38.58)	1.191 (9.66)	0.94	2.82

KEY:

V = Gross Value Added (K₺ '000s)
 E = Employment
 W = Average Wages per year

Table 27: AVERAGE ANNUAL GROWTH OF AFRICAN POPULATION
IN THE MAIN TOWNS, 1948-62 AND 1962-69
(Percentages)

<u>Town</u>	<u>1948-62</u>	<u>1962-69 /1</u>
Nairobi	6.5	15.2
Kisumu	7.2	8.7
Mombasa	7.1	7.6
Thika	10.5	5.6
Nyeri	9.1	5.2
Nakuru	6.3	4.9
Nanyuki	8.0	3.0
Eldoret	7.6	0.4

/1 Boundary changes artificially inflated some of these figures, particularly that for Nairobi, which after adjustment for annexations is reduced to about 10.5 percent, and those for Mombasa and Kisumu, which after adjustment are reduced to about 5 percent.

Source: Population census, 1969, Vol. II., from ILO/UNDP Report, Table 10, p. 48.

Table 28: DISTRIBUTION OF THE POPULATION BY EDUCATION, 1969-70
(Percentages)

<u>Category of Persons</u>	<u>Number of Years Schooling</u>				<u>Total</u>
	<u>None</u>	<u>1 - 4</u>	<u>5 - 8</u>	<u>9 or more</u>	
<u>Malé Migrants</u>					
Nairobi only	10.8	13.5	41.7	34.0	100.0
8 Major Towns	12.7	14.8	47.1	25.4	100.0
<u>Total Population</u>					
Urban and Rural	67.9	19.7	11.4	1.0	100.0

Source: Population census, 1969, Vol. III, and University of Nairobi, Institute for Development Studies: Rural-to-urban labour migration, A tabulation of the responses to the questionnaire used in the Migration Survey, by H. Rempel, J. Harris and M. Todaro, Discussion Paper No. 92 (1970). From ILO/UNDP Report Table 11, p. 49.

Table 29: ESTIMATED PERCENTAGE OF NET HOME CONSUMPTION
AFFECTED BY IMPORT LICENSING

<u>Year</u>	
1962	5.39
1963	3.61
1964	15.96
1965	21.44
1966	21.60
1967	22.24
1968	37.72
1969	27.90
1970	29.53
1971	18.73

Source: David S. MacRae, Import Licensing
in Kenya, IDS Working Paper No. 90,
Appendix B, March 1973.

Table 30: EXTENT OF EXCHANGE CONTROL CIRCULAR 1/72

Schedule	S.I.T.C. Section										Total
	0	1	2	3	4	5	6	7	8	9	
A	0.59	0.00	5.91	95.98	0.00	4.77	18.63	1.00	4.10	0.00	15.86
B	16.65	0.00	0.00	0.05	0.00	3.00	7.65	0.05	6.53	0.01	4.08
C	41.85	92.67	8.19	0.00	32.00	10.79	16.93	2.75	15.37	8.14	12.22
D	3.86	5.80	3.19	0.00	0.86	2.86	3.01	5.36	23.27	0.00	5.37
E	6.41	0.00	0.58	0.33	0.00	0.00	0.25	0.00	2.22	0.00	0.72
A to E	69.36	98.47	17.87	19.36	32.86	21.42	46.47	9.16	51.49	8.15	38.25

Note: The estimates apply the five schedules to the net home consumption figures for 1971. The table includes estimates of the proportions of six digit groups affected for those groupings where only a part of the total is brought under a schedule.

Source: David S. MacRae, Import Licensing in Kenya, IDS Working Paper No. 90, Appendix C, March, 1973.

Table 31: AVERAGE EARNINGS IN THE PRIVATE MODERN SECTOR BY RACE, 1964-71
(£)

	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>
Agriculture and Forestry								
African	50	54	57	54	58	60	62	64
Asian	571	714	625	750	857	1,167	1,400	1,600
European	1,583	1,545	1,500	1,500	1,500	1,545	1,700	2,300
TOTAL	<u>62</u>	<u>65</u>	<u>69</u>	<u>68</u>	<u>71</u>	<u>73</u>	<u>75</u>	<u>80</u>
Private Industry and Commerce								
African	129	133	176	172	201	208	223	226
Asian	516	539	513	621	634	701	816	873
European	1,408	1,489	1,385	1,582	1,591	1,776	1,964	2,167
TOTAL	<u>250</u>	<u>260</u>	<u>285</u>	<u>292</u>	<u>316</u>	<u>326</u>	<u>354</u>	<u>352</u>
Total Private Modern Sector								
African	85	89	111	114	130	135	143	149
Asian	518	543	516	625	640	712	828	890
European	1,427	1,495	1,398	1,573	1,580	1,750	1,935	2,181
TOTAL	<u>154</u>	<u>159</u>	<u>179</u>	<u>192</u>	<u>206</u>	<u>210</u>	<u>225</u>	<u>230</u>

Source: Statistical Abstract, 1972.