SHifting Kenya's private sector into higher gear

A Trade & Competitiveness Agenda
SHIFTING KENYA’S PRIVATE SECTOR INTO HIGHER GEAR
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This report is the outcome of collaborative efforts of many in the World Bank’s Kenya Trade & Competitiveness Global Practice. The team was led by Maria Paulina (Ina) Mogollon (Senior Private Sector Development Specialist) and Frank Twagira (Operations Officer), under the guidance of Catherine Masinde (Practice Manager). The team included: Nikola Kojucharov (Economist); Georgia Dowdall (Consultant); Tania Begazo (Senior Economist); Aref Adamali (Senior Operations Officer); Xavier Cirera (Senior Economist); Nora Dihel (Senior Economist); Toni Eliasz (Projects Officer); Markus Kimani (Associate Operations Officer); Jana Malinska (Senior Program Officer); Richard Mugo (Operations Officer); Sarah Ochieng (Operations Officer); Aun Rahman (Financial Sector Specialist); and Mupelwa Sichilima (Operations Officer).
“Shifting Kenya’s Private Sector into Higher Gear: A Trade & Competitiveness Agenda” was born out of the World Bank’s Trade and Competitiveness (T&C) Global Practice recent stock taking of its work in Kenya. This was part of a Programmatic Approach that aimed to organize T&C’s knowledge, advisory, and convening services to address Kenya’s development challenges in the private sector space.

By Sub-Saharan African standards, Kenya has a large private sector, which accounts for around 70 percent of total formal employment. As a result, the dynamics of the private sector are a key determinant of the trajectory of the Kenyan economy.

Although Kenya’s economy is relatively well diversified, it has a number of features that have the capacity to undermine its performance. The economy suffers from a pronounced formal – informal dualism. It is deeply divided between larger formal businesses, which are more productive and produce the bulk of economic output, and the micro and small enterprises in the informal sector, which employ the majority of working Kenyans but are characterized by lower value-added activities, poor access to capital inputs and technology, and limited connectivity to supply chain and market opportunities. Recent private sector growth has been driven by the services sector, but this has proved insufficient to address Kenya’s increasing employment challenge. Although more traditional sectors, such as manufacturing and agriculture, have the potential to absorb many of the unemployed workers, these sectors are hampered by low productivity, inefficient allocation of resources, and business environment constraints. Productivity growth across all sectors is further constrained by low innovation and limited foreign investment and presence of foreign firms. Despite Kenya’s reputation as a regional hub of innovation, the innovations of Kenyan firms tend to be incremental in nature and have a negligible impact on productivity.
By most global measures, Kenya’s business environment remains challenging. The country’s product market regulations are restrictive for domestic competitors and foreign entrants, and the actions of cartels and behavior of dominant firms across sectors undermines competition and hurts consumers. The Kenyan Government recognizes these challenges and has invested significantly in unlocking these bottlenecks with impressive results so far and several important laws passed. Additional efforts to ease regulatory constraints and expedite important legislative changes could improve the investment climate at national and county levels.

Interventions looking to address Kenya’s private sector challenges should be underpinned by the following three key goals: (i) creating more and higher value-added employment opportunities; (ii) improving firm-level productivity across sectors; and (iii) unlocking new domestic and regional market opportunities and investments. T&C supports these goals by using a multi-dimensional approach, with ongoing and future efforts centered on four core pillars:

- **Improving the investment climate** via supporting business environment reforms and strengthening investment policy and promotion;
- **Fostering competition in domestic markets and supporting increased volume and value of trade** through furthering competition policy reforms, increasing regional trade integration, and reforming services trade policies and regulations;
- **Strengthening the competitiveness of high-potential sectors** through developing job-rich domestic sectors, spatial growth solutions (such as special economic zones), and investment strategies; and
- **Fostering innovation and entrepreneurship** via promoting entrepreneurship, increasing innovation, and upgrading firm capabilities and productivity.

Building on this strategic review, in the coming months T&C will be holding brainstorming sessions with internal and external stakeholders. These sessions will aim to tap into significant collective knowledge to inform the future direction of T&C’s work in Kenya and optimize the design and implementation of upcoming programs and lending operations.
Kenya’s private sector is fairly large by Sub-Saharan African standards, and it employs the majority of the population. Measured from a national accounts perspective as the private share of total investment and consumption, Kenya’s private sector has been growing steadily since the mid-1990s; the private share of consumption and investment is now 78 percent, at the upper range of private sector sizes in Sub-Saharan countries (Figure 1). From a jobs perspective, the private sector is also the largest employer in the country, accounting for around 70 percent of total formal employment. As a result, the dynamics of the private sector are a key determinant of the trajectory of Kenya’s overall economy.

Figure 1: Size of Kenya’s private sector from a regional perspective

Source: Authors’ calculations from Stampini et al. (2011) dataset.

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1 African Development Bank (2013), “The State of Kenya’s Private Sector” (Figure 2).
Although well diversified in terms of activities, the private sector suffers from a pronounced formal-informal dualism. Services comprise slightly more than half of Kenya’s private sector activity, with agriculture accounting for around 30 percent, and industry (including manufacturing) comprising the remaining 20 percent. At the firm level, however, the private sector is deeply divided between larger formal businesses, who have higher-productivity and produce the bulk of economic output, and the MSMEs in the informal sector, who are estimated to employ around 90 percent of working Kenyans but are characterized by relatively lower value-added activities (e.g. retail trade and hospitality), poor access to capital inputs and technology, and limited connectivity to supply chain and market opportunities.

Recent private sector growth has been predominantly services-led, and this has proved insufficient to address Kenya’s growing employment challenge. Between 2006 and 2013, 72 percent of the increase in GDP came from services. Agriculture and manufacturing, on the other hand, grew slower and their share in GDP declined between 2009 and 2013. Because of their relatively low job-generating potential, growing services sectors have been unable to absorb the 3 million Kenyan youth who became of working age during this period: although financial services and communications recorded among the fastest employment growth rates (7 percent per year between 2009 and 2013), they generated less than 10,000 jobs per year. As a result, most of Kenya’s growing labor force has ended up unemployed or underemployed and in low-productivity informal activities.

Manufacturing and agriculture have the potential to absorb many workers, but these sectors suffer from low productivity, inefficient allocation of resources, and acute business environment constraints. Agriculture is the largest contributor to private employment, but its contribution to GDP has been declining. Meanwhile, the largest share of employment in manufacturing is in low value-added sectors such as food products (41 percent of total employment), textiles (8 percent),

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2 African Development Bank (2013), based on KNBS calculations from prior surveys, such as the 1998/9 labour force survey, 2009 census, 2005/6 household budget survey. Informal sector employment excludes agriculture.
apparel (5.7 percent), wood and wood/cork products except furniture (3.7 percent), and leather and related products (2.5 percent). In addition, the dispersion in firm productivity within the same manufacturing sub-sectors is high, indicating structural inefficiencies in the intra-sectoral allocation of resources that prevent firms from catching up with their successful peers. Moreover, compared to services sectors, agriculture and manufacturing are more heavily impacted by the business environment constraints which are most acute in Kenya—burdensome regulation, costly inputs (transport, energy, labor, finance), and political interference. Analysis carried out by the World Bank’s Trade and Competitiveness Global Practice (“T&C”) points out various regulatory barriers to competition in the agriculture sector ranging from rules that prevent entry and protect incumbents to rules that distort prices - which hinder sector performance.

Productivity growth across all sectors is further constrained by low innovation, and limited foreign investment and presence of foreign firms. Although relatively abundant by regional standards, the innovations of Kenyan firms tend to be incremental in nature and have negligible impact on productivity. Moreover, less than 1 percent of firms in Kenya are foreign-owned, and FDI inflows—at barely 1 percent of GDP—have consistently been below those of regional neighbors such as Tanzania, Uganda, and Rwanda over the past 15 years. This limits the scope for knowledge and technology transfers, as well as skills spillovers to domestic firms, which represent a key source of potential productivity enhancements. The level of competition in markets is also a determinant of productivity growth: the existence of cartels, preferential treatment of certain firms, and barriers to entry eliminate competitive pressure and the incentives for firms to become more productive.

Against this backdrop, Kenya’s challenge in accelerating growth and employing its growing labor force in more productive and formal activities is three-fold: (i) creating more and higher value-added employment opportunities; (ii) improving firm-level productivity across sectors; and (iii) unlocking new domestic and regional market opportunities.

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4 African Development Bank, (2013); Figures 15 and 16.
and investments. This requires a multi-dimensional approach consisting of improving the business environment, promoting competition in key domestic markets and supporting efforts to boost the volume and value of foreign trade, strengthening the competitiveness of high-potential sectors, and fostering firm-level productivity, innovation, and entrepreneurship. Each of these areas is assessed in greater detail in the following sections, taking stock of some existing initiatives and exploring key opportunities that can be leveraged going forward.

A. IMPROVING THE INVESTMENT CLIMATE

Supporting business environment reforms

According to most global measures, Kenya's business environment is challenging. A conducive business environment is one of the key pillars for private investment, enterprise growth, and job creation, and while Kenya has historically fared poorly in this regard, the GoK has recently made it a priority. According to the Doing Business rankings,\(^5\) Kenya was a top reformer amongst its peers in 2016, ranking 108\(^{th}\) among 189 countries globally. This was a significant improvement over its 2015 ranking of 129\(^{th}\). In its 2014 report on Business Environment Rankings, the Economist Intelligence Unit placed Kenya almost at the bottom among 82 countries (just ahead of Cuba, Iran, and Venezuela), and similarly, the Global Competitiveness Report for 2015-16 places Kenya below some of its African peers.\(^6\)

The Kenyan Government has recognized these challenges and invested significantly in unlocking business environment bottlenecks with the support of the WBG. In October 2014, the Doing Business Delivery Unit was launched to lead and coordinate efforts across ministries. T&C, through the second Kenya Investment Climate Program (KICP), supported the business environment reform process via technical assistance in the development and implementation of a Doing Business strategy, support to the technical working groups, reform coordination, communications, and verification.

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\(^5\) The results should be viewed in light of the limitations of the methodology such as the fact that it takes the business environment in the capital city as representative of the entire country, or that it looks at regulations as noted in legislation rather than practice.

\(^6\) Kenya (99\(^{th}\)), Seychelles (97\(^{th}\)), Zambia (96\(^{th}\)), Cote d’Ivoire (91\(^{st}\)), Namibia (85\(^{th}\)), Botswana (71\(^{st}\)), Rwanda (58\(^{th}\)), and South Africa (49\(^{th}\)).
Efforts to improve the investment climate at both the national and county-levels have resulted in significant changes. As recorded by Doing Business, over the past year, Kenya has made it significantly easier to start a business, get an electricity connection, register property, and get credit. On the regulatory front, several important business laws were passed this year. The new Companies Act 2015 updates the outdated 1948 version and significantly simplifies business-operating requirements. The Insolvency Act 2015 allows distressed companies to reorganize themselves prior to liquidation. The Special Economic Zones (SEZ) Act facilitates the process and streamlines the framework for SEZs, while the Business Registration Act 2015 allows for the establishment of an autonomous agency to guide and regulate business corporations. The automation and centralization of government services has progressed significantly through the Huduma Centers, which have centralized 52 government to citizen services; the E-citizens Portal managed by the National Treasury; the Electronic Single Window for processing of import and export permits and cargo clearance by Customs and other border agencies, including payment automation, managed by KenTrade; the Nairobi, Mombasa, and Kisumu Construction Permit Systems, the Mombasa e-Business permit system, and construction of an additional berth at Mombasa port. These initiatives could benefit from further investment and scaled up technical assistance from the WBG.

While the aforementioned changes are important steps in improving the business environment, additional efforts will be needed to further ease the burden of business regulation, simplify cumbersome processes, and automate government-to-business services. The numerous procedures and documentation required for standard business procedures, such as start-up licenses, trade, and tax payments, privilege informal arrangements over official channels and remain slow and bureaucratic. For example, despite recent improvements supported by World Bank technical assistance, it still takes 11 steps and 26 days to start a business and nine steps and two months to transfer a property title in Nairobi, both of which are slower, on average, than in the rest of Sub-Saharan Africa. A development policy loan that is focused on unlocking key regulatory constraints and expediting important legislative changes could accelerate the transformation of Kenya’s business environment.

A Development Policy Loan is a policy-based financing instrument which supports governments in implementing reforms focused on a program of policy and institutional actions.
Strengthening investment policy and promotion

Increasing investment in Kenya, both foreign and domestic, and at the national and county levels, is a key element of the country’s development. Currently, Kenya is a minor recipient of FDI compared to its neighbors, but it fares well in terms of number of investment projects. Building Kenya’s ability to attract and retain more FDI and large domestic investment is important not only as a source of jobs for Kenya’s youth but also as a means by which to attract new technologies and skills into the economy. This will play a key role in supporting Kenya’s movement from a largely factor-driven to an efficiency-driven economy.

With county governments hungry for investments and the know-how to attract them, the lack of clarity in terms of who bears responsibility for managing investors through the various stages of the investment cycle does not bode well for increasing investment at both the national and county level. Therefore, building institutional capabilities within the framework of a clear demarcation of national and sub-national roles and responsibilities will be crucial if Kenya is to attract and retain the investment it needs, at both levels. Although KenInvest is the national agency responsible for FDI, it does not have the bandwidth to service all investors and support all counties.

Addressing the need to build an investment framework that supports investor-friendly policies and procedures is the primary objective of T&C’s investment policy and promotion advisory activity. This work focuses on supporting investment through rationalizing systems relating to investment entry, incentives and retention, and building mechanisms of county coordination so that Kenya’s 47 counties ultimately go to market with a single, coherent investment offering.
B. FOSTERING COMPETITION IN DOMESTIC MARKETS AND SUPPORTING INCREASED VOLUME AND VALUE OF TRADE

*Redefining Competition policy reforms*

Competitive and open markets contribute to sustainable economic growth by facilitating increased investment and improving private sector competitiveness through cost reductions, innovation, and productivity growth. Empirical evidence strongly supports the positive effects of well-enforced competition policy on productivity growth (Buccirossi et al. 2009; Voigt 2009). Furthermore, tough enforcement against the practices of cartels is an effective tool in reducing the negative impact of anticompetitive behavior (Alexander 1994; Symeonidis 2008), benefiting consumers with lower prices, direct savings, and improvements in the variety and quality of goods and services.

By international standards, Kenya’s product market regulations are restrictive for both domestic competitors and foreign entrants. Removing these restrictive regulations in service sectors could result in an increase of GDP growth by at least 0.39 percentage points (equivalent to US$218 million in the first year). The characteristics of the regulatory framework determine the incentives and ability of firms to participate in markets and compete. Compared to other countries, Kenya’s regulatory framework is highly restrictive to firm entry and expansion. According to the Product Market Regulation (PMR) methodology designed by OECD, regulations that restrict competition are more prevalent in Kenya than in other middle-income countries (BRICS countries, Latin America and the Caribbean countries, Turkey, Romania and Bulgaria) and OECD countries. Regulations discourage investment of new firms and protect incumbent or dominant firms. Moreover, government policies and regulations render prices of goods high and harm consumers, especially the poorest.

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With WBG technical assistance, the Competition Authority of Kenya (CAK) has begun to address these various issues in recent years through targeted interventions. Five representative cases of CAK interventions carried out with WBG support and their initial impacts are highlighted below:\textsuperscript{10}

* **Price fixing in insurance:** Annual public sector savings of KSH 100 million (USD 1 million) in tenders for insurance schemes.

* **Price fixing in supermarket retail:** Annual consumer savings for retail consumers in Nairobi’s Central Business District of KSH 200 million (USD 2 million).

* **Abuse of dominance in mobile money transfer:** 9 percent fall in agent exclusivity in the mobile financial services (MSF) market compared to 2013, an 11 percentage point fall in Safaricom’s share of agents relative to its competitors, and a 10 percent overall (45 percent in rural areas) rise in the profitability of agents overall (in rural areas), indicating expanded access for Kenyan consumers to mobile financial services agents and increased incomes for small and medium MFS agents.

* Advocacy action in healthcare: Annual consumer savings in healthcare of KSH 162 million (USD 1.7 million).

* Advocacy action in agribusiness: Increased incomes to green leaf tea farmers of KSH 65 million (USD 0.7 million) per annum, the introduction of new investment and technologies in the tea sector, greater variety for Kenyan consumers, as well as an additional source of export income for Kenya.

The expected long-term benefits of these decisions and actions are expected to be broader given their ongoing natures. Going forward, further planned actions by the CAK in sectors such as beverages, telecommunications services, and shipping logistics (abuse of dominance cases) are expected. In addition, the special compliance program launched to eliminate collusive actions facilitated by business association in agriculture and financial services will render additional benefits for households and businesses. As a result of the support to build relationships between the CAK and sector regulators, the Communications Authority, the Central Bank of Kenya, the Insurance Regulatory Authority, and the Kenya Civil Aviation Authority have begun to integrate competition principles in decision-making.

In the future, efforts should focus both on stronger law enforcement to fight cartels and abusive behavior of dominant firms, and on improved regulatory design informed by competition principles. Transformation of markets to help Kenyan firms increase their competitiveness and ensure greater welfare for Kenyan citizens hinges on decisions on how the government participates in markets as a player and regulator. Technical assistance and financial resources to remove regulations that i) alter market entry conditions and reinforce dominant firms, ii) create discriminatory conditions among players, and iii) limit business strategy options and facilitate collusion are important to support this transformation. Assistance to the CAK, line ministries, sector regulators and subnational governments in expanding technical capacity,

enhancing the regulatory framework to promote competition, and deterring anticompetitive practices will catalyze change. Government support, explicitly expressed by National Treasury and the CAK, will facilitate the implementation of this reform agenda.

*Increasing regional trade integration*

Regional integration plays a critical role in connecting Kenya’s people to markets, both within Africa and with the global economy. Improving connective infrastructure and removing policy barriers to trade can help drive economic diversification, create new jobs, and reduce poverty. Combined with improved regional economic and political stability, closer economic integration enhances incentives for both domestic and foreign investment, spurring existing industries and new business start-ups.

Although Kenya currently dominates intra-EAC trade, there is still considerable scope for further gains. In 2013, total trade flows within the EAC were estimated at almost $5.1 billion, with intra-EAC exports in particular having increased by over 45 percent from 2010 to 2012, making the EAC member states one of the major export destinations for the community as a whole (accounting 15 percent of the total). As the biggest contributor to this intra-EAC trade, Kenya (followed by Uganda and Tanzania) stands to benefit significantly from still-untapped opportunities for increased cross-border trade in basic manufactures that are costly to import from the global market, such as metal and plastic products, as well as improved access to cross-border services that are cheaper and provide a wider variety than those currently available.

Despite decisive steps by Kenya and other EAC members to accelerate integration, much remains to be done to fully leverage regional integration to drive job creation and poverty reduction. EAC countries have made considerable efforts to develop shared infrastructure and implement reforms to improve transit and transport infrastructure, particularly along the northern and central corridors, as well as to establish regional and national mechanisms for the removal of non-tariff
barriers (NTBs).\textsuperscript{12} T&C has supported this effort at the EAC level through work focusing on regulatory reform, regulatory quality and transparency, and monitoring mechanisms. Notable analytical services and advisory milestones include the following: the publication of the inaugural EAC Common Market Scorecard that measures partner states’ commitments in the free movement of goods, capital, and services under the EAC Common Market Protocol; the publication of four EAC Doing Business Reports; the harmonization of five key agricultural seed certification standards; the harmonization of EAC tax administrative procedures through an EAC Council of Ministers Directive; a feasibility study for an EAC regional business registry; a regulatory capacity assessment of the EAC Secretariat; and a series of peer-to-peer/ network of reformers knowledge events. In Kenya, T&C has supported the creation of more efficient trade logistics systems and services, in particular through (i) the simplification of documentation, procedures and processes, (ii) the re-engineering and automation of business processes at trade logistics agencies, and (iii) significant support to the implementation of the electronic single window system.

The next round of efforts must focus on improving the connectivity of the poor to regional and global markets and lowering Kenya’s high trade costs by removing trade barriers and enhancing trade systems throughout the trade logistics value chain. The poor in Kenya remain disconnected from foreign markets on account of both physical barriers—i.e. poor access to transport and energy—and regulatory and institutional barriers that impede the efficiency and effectiveness of key services and raise their costs. The way forward must be two-fold: (i) lowering explicit external barriers to trade related to market access and national treatment; and (ii) addressing internal regulatory barriers and competition issues, for example, by eliminating unnecessary requirements and fees, simplifying regulations and procedures, and applying the latter in a transparent and predictable way.

\textsuperscript{12} For example, since 2014, there have been improvements in the turnaround of movement of cargo from the port in Mombasa (Kenya) to Kampala (Uganda) from 18 to four days, and from Mombasa to Kigali (Rwanda) from 21 days to six days. Kenya, Uganda, and Rwanda have introduced a single tourist visa, and markets are starting to emerge for the movement of professionals within the region through a framework for mutual recognition of professional standards.
Reforming services trade policies and regulations

Services are a key intermediate input into other sectors such as agriculture and manufacturing, and their availability and quality can be an important determinant of firm productivity and competitiveness. Among other things, increased integration of services (a.k.a. “servicification”) into manufacturing and other production activities can help firms to do the following: (i) become more productive through the use of services in logistics, management or engineering that save time, materials, and improve coordination; (ii) differentiate their products by bundling services with their other products; (iii) overcome informal barriers to foreign market entry and to sustain foreign market sales (e.g. by using foreign language interpretation, matchmaking, and monitoring services); and (iv) join and manage international production networks and value chains.

However, Kenya’s services sector currently creates fewer forward linkages than is predicted by its income per capita level (Figure 3). Kenya outperforms other countries of similar income per capita in all three measures of services export shares (gross, direct, total). However, forward linkages have a small role to play given that Kenya’s relative position drops when considering total value added of services exports. This finding illustrates that some of the services sectors in Kenya, such as telecommunications, financial services, and transport have prospered owing to an intrinsic development path rather than being pulled by other sectors through forward linkages. The fact that manufacturing exports have been stagnant (relative to GDP) confirms this finding. This suggests a need for further analysis of the specific links between services and non-services sectors in Kenya, their potential role in driving economic upgrading of firms, and the policy and regulatory reforms to improve their quality, availability, and accessibility.

\[\text{Forward linkages}^{13}\] The contribution of services as an input to other sectors’ exports. For example, the business process outsourcing (BPO) firm may be providing services to a domestic manufacturing firm which exports its products. The share of the BPO firm’s input to the manufacturing good exports count as a forward linkage.
C. STRENGTHENING THE COMPETITIVENESS OF HIGH-POTENTIAL SECTORS

Developing job-rich domestic sectors

Manufacturing has an important role to play in putting Kenya on a higher growth path because it can create productive employment. With its strong linkages to many other sectors of the economy, manufacturing directly and indirectly stimulates economic activity throughout the economy-wide supply chain. Manufacturing is also a source of tradable goods, potentially strengthening a country’s terms of trade and facilitating global integration and knowledge spillovers, which are critical in promoting structural transformation.14 Manufacturing can also contribute to the diversification of the economy, thus helping mitigate volatility.

Figure 3: The role of services as an input to other sectors’ exports is low in Kenya (as percent of total exports of goods and services, in percent)

Despite its potential, recent growth in the manufacturing sector has trailed the rest of the economy (Figure 4). Between 2010 and 2014, real growth in manufacturing averaged around 4 percent annually compared to roughly 5.5 percent in the rest of the economy, and the sector’s share in total GDP fell by close to 1 percentage point.

14 Structural transformation refers to the process of an economy moving from predominantly agricultural activities to industry and services.
Several key subsectors such as agribusiness, apparel, leather, and furniture are particularly labor-intensive, and if their competitiveness is improved, they have the potential to absorb thousands of workers. Similar factors constrain these various sub-sectors: a challenging business environment; vested interests in the upstream parts of the value chains; limited dialogue and collaboration; policy uncertainty; difficult access to markets; rudimentary technology and limited managerial and technical skills (particularly within the informal sector); and low overall productivity and high intra-sectoral dispersion in productivity. The Government, through its Ministry of Industrialization, has prioritized these sub-sectors, and T&C has supported them through rigorous analytical work and diagnosis. The Government is keen on seeing the WBG continue its support to these sectors and issues of productivity more broadly.

Agribusiness has been an area of significant WBG focus given its job creation potential and its backward linkages to smallholder farmers. Agriculture today makes up 25 percent of GDP and 50 percent of exports earnings. Challenges facing the sector include the lack of a coherent land policy, a poor legal and regulatory framework impeding private investments in key value chains, costly and poor quality inputs, poor
infrastructure, heavy pre- and post-harvest losses, and limited capital and access to affordable credit. To address some of these challenges, T&C has supported the Government in the following: (i) the design and implementation of a warehouse receipts system which provides the foundation for a structured trading system and crop collateralization; (ii) the development of seed sector regulations to operationalize the Seed and Plant Varieties Act 2013; and (iii) support to both Government and private sector to unlock investment constraints in select value chains through targeted initiatives and public private dialogue.

Relatively job-rich services sectors such as tourism also hold the potential to contribute to more rapid employment growth. The MTP-2 aspires to double the number of foreign tourists to 3 million by 2018. The resulting impact on growth and employment could be significant. Based on data from the World Travel and Tourism Council (WTTC), the total (direct and indirect) contribution of tourism in Kenya’s 2012 GDP reached 12 percent of GDP. Moreover, it created 230,000 jobs and an additional 360,000 jobs indirectly. These figures are controversial and little consensus exists among different parts of the Government and the private sector regarding tourism’s contribution to the economy. To that end, the WB is providing analytical support to provide an unbiased estimate of the latter and helping to bring different stakeholders together around a common understanding of the weight of tourism in Kenya’s economy.

Developing spatial growth solutions and investment strategies

With the Special Economic Zones (SEZ) Law now in place, Kenya has an opportunity to attract significant new investments, both foreign and domestic, and unlock value chain potential for investment growth and jobs. The Government has developed the Kenya Industrial Transformation Program, aimed at making Kenya an industrial hub for Africa through targeted, sector-specific interventions. To accelerate industrial development, the Government is employing a variety of spatial growth solutions such as SEZs and industrial parks. This integrated approach can help spur job creation and investment generation, and increase exports and technology transfer. Major investments in agribusiness, textiles,
apparel, automotive, food processing, logistics and conference tourism are planned for SEZs and industrial parks, making these a key component of Kenya’s industrialization process. T&C supported the Government in the design of the SEZ Law which was recently enacted. Support in drafting the implementing regulations and conducting market demand analytics for select SEZ sites is ongoing. Going forward, the Government will need to design and establish the SEZ Authority, conduct project feasibility and market demand studies for additional SEZ sites, design and implement an SEZ communications campaign, promote investments in the SEZ, identify anchor tenants and developers, and build out some of the core infrastructure. A combination of technical assistance and investment lending could be key to ensure the success of the Government’s SEZ program, leveraging international best practices and lessons learned in other parts of the world.

D. FOSTERING INNOVATION AND ENTREPRENEURSHIP

Promoting entrepreneurship

Kenya exhibits higher rates of entrepreneurship compared to other countries with similar income per capita, albeit predominantly in activities with lower economic complexity. Various data suggest that Kenya is an entrepreneurial nation with higher rates of formal business creation than some of its peers with similar income levels (Figure 5) and more firms that are proactive in reaching foreign (including regional) markets, though their successes are rare. However, Kenya’s economic complexity, as measured through its exports structure, is lower than its peers:15 capabilities are diversified but mostly in low complexity goods such as tea or coffee, and they have not been increasing in recent years—indicating new entrant firms are engaging primarily in activities with relatively lower economic sophistication. The concentration of informal firms in relatively lower value added activities suggests a similar trend for informal entrepreneurship.

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15 Kenya’s economic complexity is higher than the other SSA peers as well as Bangladesh and Cambodia, but lower than the better performing peers such as Vietnam, India, or Pakistan. The three peers from East Asia (China, Indonesia, and Thailand) also had much higher complexity in 1995 (first year of available data) compared to Kenya’s in 2012. Kenya’s top four exports by total value are among the least complex goods traded globally.
The GoK’s Vision 2030 emphasizes ICT as a high-potential sector for increased entrepreneurship in more economically-sophisticated and technology-oriented fields. There has been remarkable growth in the ICT sector, particularly in the mobile sector, which by September 2013 had 31.3 million subscribers and a penetration of 76.9 percent. At the same time, there were 25.1 million mobile money subscribers and an estimated 19.1 million Internet users, with 47.1 per 100 inhabitants having access to Internet services. The Kenya ICT Masterplan aims to leverage this ICT momentum to create an enabling environment for digital entrepreneurship and opportunities for Kenyan youth, who are at the crux of the digital economy.

Important digital entrepreneurship support initiatives are already underway. The iHub in Nairobi, Kenya’s first technology and innovation lab, was established in 2010 and has become the centerpiece of the growing digital technology community in Kenya with over 16,500 members. iHub has several initiatives that catalyze the growth of the community by developing and connecting people, supporting start-ups, and surfacing information. One of these key initiatives is the m:lab East Africa, which was launched in November 2010 through a $725,000 World Bank grant. The m:lab’s mission is “to facilitate demand-driven innovation by regional...
entrepreneurs, ensuring that breakthrough low-cost, high-value mobile solutions can be developed and scaled-up into sustainable businesses that address social and economic needs. The Kenyan Government considers innovation hubs and incubation centers such as the iHub and the m:lab as key stakeholders in the creation of tech businesses and subsequently, in creating jobs, and the WB is keen to continue its support to them.

**Increasing Innovation**

Analysis of the 2014 Enterprise Survey Innovation Module (ES-IM14) suggests that innovation rates in Kenya are high compared to some emerging countries that have implemented national innovation surveys. Between 2010 and 2012, around 45 percent of the surveyed firms in Kenya introduced a product or process innovation, defined as a substantial change to products or processes. On the other hand, a much smaller share of firms introduced organizational changes (37 percent). These firm innovation rates compare favorably to Tanzania, Ghana, Russia, Poland and other economies (Figure 6).

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**Figure 6: Technological innovation-product or process (% of all firms)**

![Bar chart showing technological innovation by country](chart_url)

Source: Enterprise Surveys

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16 The ES-IM14 sample is a stratified sample by sector and location. It contains 549 firms, 51 percent of which are in manufacturing, and the remaining in services, mainly in wholesale and retail trade. The size composition includes 17 percent large firms, 33 percent medium firms, 43 percent small firms, and 7 percent micro firms.

17 However, comparing firm innovation across countries has some caveats due to the subjective nature of measuring innovation through surveys.
Although widespread, the innovations Kenyan firms make are typically incremental. Results from a 2014 innovation survey suggest that the likelihood of Kenyan firms to innovate are high compared to other developing countries, though the subjective nature of the results make cross-country comparisons challenging. Nevertheless, while most firms say they have introduced some type of a product or process innovation, only few have actually come up with things that are new to the domestic market. The fact that these innovations have not been accompanied by productivity gains in most cases confirms the point that Kenya still has a long way to go.

In addition, when actual investment in innovation is compared across countries, the magnitude of innovation among Kenyan firms becomes less impressive. The share of firms’ spending on R&D in Kenya is 40 percent lower than in Ghana or Egypt, and less than half of South Africa’s. Also, a relatively lower share of Kenyan firms acquire machinery, equipment, and software, and the same is true of spending on training.

In this context, the World Bank has been supporting the development of enabling infrastructure and services for innovation, which to date are limited in Kenya but can play an important catalytic role going forward. Innovation hubs and incubators such as the iHub, m:Lab (partially financed by a World Bank grant), and NaiLab (supported through the Kenya Transparency and Communication Infrastructure Project), are a very recent phenomenon in Kenya and still fairly limited in their reach. The Kenya Climate Innovation Center (CIC) was also established in 2012 to provide holistic, country-driven support to accelerate the development, deployment, and transfer of locally relevant climate and clean energy technologies. The CIC provides incubation, capacity building services, and financing (through an embedded seed fund—the Climate Venture Facility) to Kenyan entrepreneurs and new ventures that are developing innovative solutions in energy, water, and agribusiness to address climate change challenges.18

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18 The Kenya CIC is an initiative supported by the World Bank’s infoDev and is the first in a global network of CICs being launched by infoDev’s Climate Technology Program (CTP). The Kenya CIC is funded by the United Kingdom’s UKaid and the Danish Ministry of Foreign Affairs.
Upgrading firm capabilities and productivity

Recent analyses of firm-level data suggest that the incremental nature of Kenya's innovation and its low impact on productivity may relate to difficulties firms face in leveraging technology. Manufacturing subsector analyses have shown that firms operate using outdated technology, in silos within their respective value chains, and with a skills deficit both at the managerial and technical levels. Preliminary analysis suggests the same trends hold true across the services sectors. This implies that many Kenyan firms operate far away from the technological frontier, significantly constraining growth and competitiveness. This is particularly true for firms in the informal sector, where access to modern technologies is especially limited, as is the access to finance to invest in modern equipment. Access to markets also plays a role, particularly for the informal sector, which has seen its clientele increasingly move away from informal retail.

Kenya’s relatively high managerial capacity is an asset that can support higher innovation, but there is still catching up to do. Managerial capacity—a key recipe for enhancing productivity through innovation—is relatively high in Kenya given its level of income per capita, and most of the productivity differences observed in Kenya are between firms that implement organizational innovations and those that do not implement such innovations. But while Kenya’s score is higher than in other African countries, management quality is still far from the “managerial” frontier, represented by management practices in OECD countries such as the US or Japan, and more importantly below managerial capabilities in most middle-income and emerging markets. This suggest considerable scope for further productivity growth through investments in improving firms’ internal capabilities, especially around management and organization, as well as strengthening the quality of tertiary education and the linkages between academia and businesses.

Draft analyses on apparel, food processing, furniture, and leather subsectors, prepared under the Kenya Export Competitiveness and Innovation NLTA.
REFERENCES


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