UNLOCKING GROWTH POTENTIAL IN KENYA

DISMANTLING REGULATORY OBSTACLES TO COMPETITION

November, 2015
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The report is based on the World Bank Group Markets and Competition Policy Assessment Tool (MCPAT), which is used to identify and assess the potential anticompetitive effects of Government intervention in markets, inform the development of effective strategies to promote competition and provide technical support on competition-related issues in emerging economies.

The CAK team involved in the preparation of this report was led by Francis Kariuki (Director-General), and included Lilian Mukoronia (Manager, Advocacy), Stellah Onyancha (Head, Mergers & Acquisitions), Boniface Makongo (Chief Legal Officer), and Faith Odhiambo (former Young Professional).

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## ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>ACDI</td>
<td>Agricultural Cooperative Development International</td>
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<td>ACF</td>
<td>African Competition Forum</td>
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<td>AFFA</td>
<td>Agriculture, Fisheries and Food Authority</td>
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<tr>
<td>ATM</td>
<td>Automatic Teller Machine</td>
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<tr>
<td>CA</td>
<td>Communications Authority of Kenya</td>
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<tr>
<td>CAF</td>
<td>African Competition Forum</td>
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<tr>
<td>AFFA</td>
<td>Agriculture, Fisheries and Food Authority</td>
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<tr>
<td>ATM</td>
<td>Automatic Teller Machine</td>
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<td>CA</td>
<td>Communications Authority of Kenya</td>
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<td>CBK</td>
<td>Central Bank of Kenya</td>
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<td>CCK</td>
<td>Communication Commission of Kenya</td>
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<td>CLC</td>
<td>Communication Licensing Committee</td>
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<td>COMESA</td>
<td>Common Market for Eastern and Southern Africa</td>
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<td>EAC</td>
<td>East African Community</td>
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<td>EAGC</td>
<td>Eastern Africa Grain Council</td>
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<td>EC</td>
<td>European Commission</td>
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<td>EOI</td>
<td>Expression of Interest</td>
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<td>EPZ</td>
<td>Export Processing Zone</td>
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<td>ERC</td>
<td>Electricity Regulatory Commission</td>
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<td>EU</td>
<td>European Union</td>
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<tr>
<td>FAO</td>
<td>Food and Agriculture Organization</td>
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<td>FCFS</td>
<td>First Come First Served</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FIT</td>
<td>Feed-in Tariffs</td>
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<td>GAIN</td>
<td>Global Agricultural Information Network</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GLA</td>
<td>Green Leaf Supply Agreement</td>
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<td>GNP</td>
<td>Gross National Product</td>
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<tr>
<td>GoK</td>
<td>Government of Kenya</td>
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<tr>
<td>ICPAK</td>
<td>Institute of Certified Public Accountants of Kenya</td>
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<tr>
<td>ICT</td>
<td>Information and Communication Technology</td>
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<tr>
<td>IEA</td>
<td>Institute of Economic Affairs</td>
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<td>IFC</td>
<td>International Finance Corporation</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IPA</td>
<td>Investment Promotion Act, 2004</td>
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<td>IPP</td>
<td>Independent Power Producer</td>
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<td>IRA</td>
<td>Insurance Regulatory Authority</td>
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<td>KAA</td>
<td>Kenya Airports Authority</td>
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<td>KAGRC</td>
<td>Kenya Animal Genetic Resources Centre</td>
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<td>KARI</td>
<td>Kenya Agricultural Research Institute</td>
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<td>KCAA</td>
<td>Kenya Civil Aviation Authority</td>
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<tr>
<td>KCB</td>
<td>Kenya Commercial Bank</td>
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<tr>
<td>KENFAP</td>
<td>Kenya National Federation of Agricultural Producers</td>
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<tr>
<td>KenGen</td>
<td>Kenya Electricity Generating Company</td>
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<tr>
<td>KenInvest</td>
<td>Kenya Investments Authority</td>
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<tr>
<td>KETRACO</td>
<td>Kenya Electricity Transmission Company Limited</td>
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<tr>
<td>KNBS</td>
<td>Kenya National Bureau of Statistics</td>
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<tr>
<td>KPLC</td>
<td>Kenya Power and Lighting Company</td>
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<td>KSB</td>
<td>Kenya Sugar Board</td>
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<td>KSH</td>
<td>Kenya Shilling</td>
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<tr>
<td>MNO</td>
<td>Mobile Network Operator</td>
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<tr>
<td>MT</td>
<td>Metric Ton</td>
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<tr>
<td>MVNO</td>
<td>Mobile Virtual Network Operator</td>
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<tr>
<td>NBO</td>
<td>Jomo Kenyatta International Airport (JKIA)</td>
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<tr>
<td>NCPB</td>
<td>National Cereals and Produce Board</td>
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<tr>
<td>OECD</td>
<td>Organisation of Economic Cooperation and Development</td>
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<tr>
<td>PBK</td>
<td>Pyrethrum Board of Kenya</td>
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<td>PMR</td>
<td>Product Market Regulation</td>
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<td>PPA</td>
<td>Power Purchase Agreement</td>
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<td>PPCK</td>
<td>Pyrethrum Processing Company of Kenya</td>
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<td>PPP</td>
<td>Public-Private Partnership</td>
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<td>SAFEX</td>
<td>South African Futures Exchange</td>
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<td>SAP</td>
<td>Structural Adjustment Program</td>
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<td>SGR</td>
<td>Strategic Grain Reserve</td>
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<td>SME</td>
<td>Small and Medium Enterprises</td>
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<td>SMS</td>
<td>Short Messaging Service</td>
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<tr>
<td>SOE</td>
<td>State-Owned Enterprise</td>
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<td>SSA</td>
<td>Sub-Saharan Africa</td>
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<tr>
<td>UK</td>
<td>United Kingdom</td>
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<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
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<tr>
<td>USA</td>
<td>United States of America</td>
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<tr>
<td>USAID</td>
<td>United States Agency for International Development</td>
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<tr>
<td>USDA</td>
<td>United States Department of Agriculture</td>
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<tr>
<td>USSD</td>
<td>Unstructured Supplementary Service Data</td>
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<tr>
<td>VAT</td>
<td>Value Added Tax</td>
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<tr>
<td>VOCA</td>
<td>Volunteers in Overseas Cooperative Assistance</td>
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<tr>
<td>WB</td>
<td>World Bank</td>
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<tr>
<td>WRS</td>
<td>Warehouse Receipt System</td>
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According to economic theory and empirical studies, regulations that impair market functioning have the potential to adversely affect the economy: they can impede the development of otherwise competitive markets, unnecessarily constrain business operations, and negatively affect consumers. This report draws on extensive economic literature and success stories from other countries, where a reduction of regulatory obstacles to competition led to significant economic improvements in the form of economic growth, productivity growth, and export competitiveness. It guides and supports the advocacy actions of the Competition Authority of Kenya (CAK) to foster competitive markets in Kenya and contribute to achieving Vision 2030, whose aim is to create a globally competitive and prosperous nation with a high quality of life. According to this analysis, the removal of restrictive product market regulations in Kenya’s service sectors such as professional services and electricity would result in an increase of GDP growth by at least 0.39 percentage points (equivalent to US$218 million in the first year) compared to a situation with no reforms.¹ ²

To promote a pro-competitive environment in Kenya, this report focuses on competition advocacy, a key aspect of competition policy. In general, competition policy aims to foster market principles throughout the entire economy. Competition policy usually involves (i) the enforcement of antitrust laws (typically, rules against abuse of dominance, anticompetitive agreements, and merger control); and (ii) the promotion of measures to enable firm entry and rivalry, typically referred to as competition advocacy. Competition advocacy encourages policies and actions aiming at (i) easing market entry barriers and guaranteeing equal business opportunities to market participants, (ii) injecting market principles into the operations of state-owned or controlled enterprises, (iii) playing the role of a competition advocate in order to ensure sectoral policies follow market principles, and (iv) developing a culture of competition by instilling a competition mindset into the players in the market.

There are a number of reasons why governments intervene in the markets by adopting regulations: one essential motive is economic. In particular, rules might be needed in order to address market failures. Governments aiming to attain public policy goals sometimes use regulatory instruments so as to control monopoly power or negative externalities from adversely affecting consumers. However, in some cases, regulations can have unintended negative effects on the way markets function and eliminate firms’ incentives to compete.

Therefore, assessing the regulatory framework means understanding what a particular rule is seeking to achieve and then evaluating whether there are less restrictive policy options that can achieve the same policy objective. Regulatory obstacles to competition include inappropriate rules and regulations that alter entry conditions in a market, create discriminatory conditions among players, limit businesses’ strategy options, and impede consumer choice.

Ideally, the principle guiding the regulatory set-up would be selecting the instrument that would cause the least distortive effect on competition in the market and one that would create incentives for firms to deliver the best deals for consumers.

This report seeks to pinpoint regulatory obstacles that may hinder effective competition and economic growth in Kenya, and to recommend pro-competitive reforms.

¹ Throughout the report, all dollar ($) amounts are US dollars unless otherwise indicated.
² Further details of the quantification of these estimates are provided in Annex 5.
The World Bank Group’s Markets and Competition Policy Assessment Tool (MCPAT) was used for the analysis.

This report benefitted from the use of several competition indicators, interviews with stakeholders, and economic analysis. An initial assessment was based on the Product Market Regulation (PMR) indicators, developed by the Organization of Economic Co-operation and Development (OECD) and calculated for Kenya in collaboration with the World Bank Group.

Using these methodologies, this report identifies both regulations that alter the whole economy by affecting the ability and incentives of firms to enter the market and compete, and regulations that affect only specific sectors. The specific sectors have been selected based on their relative importance to the economy, their alignment with the objectives of Kenya’s Vision 2030, and a preliminary analysis of the restrictiveness of the regulatory framework on competition across candidate sectors.

The general panorama in Kenya: A relatively high level of government intervention in markets where the private sector is already present, and significant, non-justifiable regulatory requirements to enter into new markets

According to the PMR indicators, regulations that restrict competition are more prevalent in Kenya than in other middle income countries (BRICS countries, Latin American and the Caribbean countries, and other middle-income countries such as Turkey, Romania and Bulgaria) and OECD countries. At a broad level, findings show that great improvements could be achieved in Kenya by undertaking reforms in order to:

1. Limit government intervention and the role of State-Owned Enterprises (SOEs) to situations where the private sector is unable to operate. Kenya has SOEs in sectors that in many other countries are more open to private companies, such as banking, wholesale and retail trading, and agroprocessing. PMR scores show that when compared with OECD and Latin American and Caribbean countries (LAC), Kenya’s score for state control is higher.

2. Limit barriers to entry and rivalry, and in particular, review rules that are likely to create discriminatory conditions between market players and limit their business strategy options. According to the PMR index, Kenya is one of the countries in the sample where barriers to entrepreneurship are most significant. These barriers are a result of burdensome entry regulations that are not as common globally, and an uncontrolled system of license and permit requirements at the national and subnational levels.

3. Limit barriers to trade and investment. The PMR index confirms that barriers to trade and investment are higher in Kenya than in the OECD, LAC and BRICS countries. This is due to the limited use of mutual recognition agreements and international standards and certification procedures, as well as differential treatment of foreigners with regard to public procurement, and relatively higher import tariff rates for agricultural products.

Agriculture: Optimizing government intervention in markets to increase agriculture productivity, expand private investment, and reduce consumer prices of basic staples

The Kenyan agriculture sector is vital because it represents the largest fraction of the economy and is the main source of income for many Kenyan families. Moreover, it is closely linked to the country’s food security policy improving efficiency in this sector can have a direct impact on poverty reduction. In this report, the analysis mainly focused on the following subsectors: staple grains, pyrethrum, tea, sugar, and input markets.

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3 The PMR scores are calculated on a scale of 0-6, reflecting increasing restrictiveness of regulatory provisions for competition.
4 In the Kenya Economic Survey (2014), agriculture contribution to GDP in 2013 was estimated to be up to 25.3 per cent, and FAO Stat data shows that more than two-thirds of the working population is employed in the agriculture sector, however, only a small fraction of this figure accounts for formal employment.
Burdensome and ineffective government intervention was identified as the main challenge to competition in the agriculture sector. In the maize sector for instance, the government heavily influences the normal functioning of the maize market through the fully state-owned National Cereal and Produce Board (NCPB) and through import tariffs (currently, maize is imported at a 50 percent duty rate), which may lead to higher prices for consumers. Furthermore, stakeholders have claimed that the NCPB, uses numerous intermediaries, both upstream and downstream, making the procurement and distribution process inefficient, slow, and costly. NCPB also distributes maize seeds, thereby affecting the seeds market, and imports and distributes fertilizer at a subsidized rate. It is therefore recommended that the overall mandate and scope of action of the NCPB be reviewed and alternative, less-distortive measures be implemented. The Government of Kenya (GoK) has taken some steps in this direction.

Government policies that tend to keep prices of agriculture products artificially high will generate a particularly negative impact in markets for staple food, especially since empirical evidence suggests that poor households are often net consumers of agricultural products rather than net producers.\(^5\) Lowering import barriers and eliminating policies that influence prices would increase competition in the market, and consumers would benefit from lower food prices. Targeted support to vulnerable farmers could complement these policies and minimize negative effects in the entire staple food market.

Opening up the markets to private investment and rationalizing regulation will improve market performance and attract investments in industrial crops. For example, in the case of pyrethrum,\(^6\) a dramatic decline in production has been linked to regulatory issues that eliminated entry into the industry. The main challenges were related to the previous role of the Pyrethrum Board of Kenya (PBK) as a monopsonist in the purchase of dry pyrethrum flowers and a monopolist in the sale of refined pyrethrum in Kenya. Although a new agriculture framework, which allows private participation, was established in 2013, a clear and transparent system for granting processing licenses has yet to be implemented. Additionally, there are still provisions that may unnecessarily restrict competition through limits on the ability of farmers to switch processors.

In the sugar and tea sectors, unreasonably high trade barriers, such as excessive import duties and non-tariff barriers (NTBs), and restrictive domestic regulations, are an issue. In the sugar industry, non-tariff barriers (particularly, quotas and mandatory import permits) have often impeded imports or made them more costly. This has resulted in a failure to drive down local sugar prices to levels found in more efficient COMESA countries, thereby harming consumers – particularly the poor. Regulations which may hinder entry in the tea sector include minimum hectarage requirements for factories and various restrictions on the ability of factories to source leaves and on growers to decide to whom they sell.

Wireless telecommunications: Facilitating consumer mobility and access to essential resources such as radio spectrum to sustain competition

Notwithstanding the progress made thus far in boosting competition in the mobile services market, there is some room for improvement by reducing consumer switching costs. Currently, there are three private mobile telecommunications companies, Safaricom, Airtel and Telkom Kenya (Orange).\(^7\) After the

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\(^5\) See Christiaensen and Demery (2007), Wodon et al. (2008), and Wodon and Zaman (2008).

\(^6\) Pyrethrum is a natural insecticide of which Kenya used to be the world-leading exporter until a few decades ago. Production peaked in the early 1980s, when Kenya accounted for more than 80 percent of the global supply, but it dramatically declined by the end of 1980s, never recovering to the previous production rates.

\(^7\) Essar Telecom has exited the market. It sold its assets to Safaricom and transferred its customers to Airtel.
introduction of mobile number portability in 2011, the quarterly report of the Communication Commission of Kenya (CCK)\(^8\) pointed out that operators had developed strategies to increase consumer fidelity, indicating that portability may have caused some changes in consumer behavior. Nevertheless, the pro-consumer effects are likely to be limited by the fact that switching costs still appear to be relatively high due to factors such as the porting fee and delays faced in porting.

Reducing or eliminating the porting fee currently imposed on porting consumers\(^9\) and automating the switching process will render number portability more effective. The regulator could evaluate whether the alleged administrative cost of 200 Kenya shillings is disproportionate and reflective of artificial barriers to switching. It may be socially more efficient if the administrative costs of number portability are covered by the prices that firms charge for their services to all consumers. Indeed, switching consumers generate a positive externality on other consumers as they trigger the competitive process that leads to lower prices or other commercial conditions that are beneficial for all consumers. It is also important to guarantee that consumers are never left without a working number during the switching process.

Wireless technology is becoming increasingly important, and operators seeking to compete in telecommunications markets require access to radio spectrum; however, in Kenya there is a lack of pro-competitive process for spectrum assignment. The Communication Authority (CA) is vested by law with the responsibility of managing the frequency spectrum.\(^10\) The Ministry of Information, Communications and Technology has acknowledged the importance of updating spectrum management practices in order to foster growth in broadband networks.

To tackle this, it has recently drafted the Wireless Broadband Spectrum Policy Guidelines, currently under review after receiving stakeholders’ comments. Nonetheless, the digital switchover (DSO) - the transition from analogue to digital technology for the delivery of television and radio broadcast services – will free up spectrum, the current regulatory framework provides only for an administrative first-come first-served mechanism to assign spectrum. Policies are needed to efficiently allocate spectrum in a manner that does not limit competition in the provision of communication services.

Notwithstanding progress made in terms of discussing policies for granting spectrum to market players, considering the assignment of the 4G spectrum, for high speed wireless communications, it is recommended that the CA follows mechanisms that ensure efficient allocation of resources considering the effects on competition. The CA has the opportunity to lead the process of developing clear, transparent, and predictable rules for allocating spectrum to firms while working together with the CAK to advocate for pro-competition rules. Safaricom, Kenya’s first provider of 4G Internet services, is expected to be granted a definitive spectrum license following an administrative process resulting from signing a KSH 15 billion (US$166 million) agreement with the government to build a national security and surveillance system in December 2014, which offered Safaricom the chance to access the 4G radio spectrum in the 800 Mhz band.\(^11\)

Projects that involve granting spectrum or other scarce government resources for carrying out government social and infrastructure projects to Public-Private Partnerships (PPPs) would benefit from prioritizing a competitive process.

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\(^8\) The CCK has been renamed as the Communication Authority of Kenya (CA).
\(^9\) Ideally, porting fees should be eliminated. A less efficient alternative consists of imposing cost-based porting fees. This latter solution is not the first best option, but it represents an improvement from the current set-up.
\(^10\) The Kenya Information and Communications Act 1998 and Kenya Information and Communication Amendment Act 2013
for selecting the most suitable partner and financial conditions. PPPs have the potential to affect competition by strengthening the private partner’s position in the market. To ensure that the design of a PPP minimizes potential negative effects on competition, it is important to guarantee that government contributions (in terms of assets, investment, value of land, spectrum, and others) are calculated correctly and do not allow for unjustifiable excess profit. Unsolicited proposals should be evaluated carefully, with due consideration of other alternatives and an assessment of the PPP’s potential effect on markets and competition.

Mobile payment systems: Introducing regulatory elements to facilitate competition for the benefit of consumers

The most popular payment system in Kenya, mobile payment, is dominated by the first firm that entered the market. Mobile money transfer services offer a platform to send and save money, pay salaries, utilities and other bills, and purchase goods and services online and in physical markets. The number of subscribers using this service reached more than 26 million by 2013.\(^\text{12}\) This significant growth was mainly due to the efficiency and convenience of this service. In 2014, M-PESA – a system sponsored by Safaricom - held 74 percent of the market share in terms of subscriptions and almost 70 percent in terms of the number of agents affiliated with the network.\(^\text{13}\) The remainder of the market was held by Airtel Money, Orange Money, and Essar’s Yu Cash which has subsequently exited the market.

Recent developments may help to increase competitive pressure in this market. Safaricom’s position has recently been challenged by Airtel, its main competitor, who in 2014 filed a complaint with the CAK asking the authority to probe Safaricom for abusing its market-leading position. Moreover, Equity Bank – a bank focused on small and medium enterprises obtained a Mobile Virtual Network Operator (MVNO) license through its subsidiary Finserve Africa (Equitel) and recently launched a mobile banking and money transfer service, becoming a new source of competition given Equity’s importance in the financial sector. Furthermore, the CAK intends to carry out a study on one of the priority areas for competition in mobile financial services - namely, access by financial institutions to USSD codes managed by mobile operators. The cost and conditions for accessing the USSD short codes used by customers to access mobile financial services provided by other institutions determine the competitiveness of those institutions vis-a-vis the mobile operator.

It is advisable to monitor the effective elimination of exclusive contracts between mobile payment providers and merchants (agents). Exclusive contracts foreclose the market to smaller players or new entrants, reducing competition and keeping prices high. In July 2014, the CAK entered into a settlement agreement with Safaricom that eliminated exclusivity of agents for mobile transfers. Efforts should be devoted to ensure this agreement is enforced by Safaricom and its aggregators that, who that have direct contact with agents.

In order for effective competition to be preserved in the market, it would be worthwhile to consider mechanisms for facilitating full interoperability among the different mobile payment providers in Kenya and increasing transparency of the fees charged for the service. The former would render switching easy for consumers, increase competition among operators, and reduce the network effects which heavily shape the current market structure. Increasing transparency of fees will allow consumers to compare the offerings of alternative providers based on the price of the service, creating more competitive pressure.

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These figures are likely to underestimate the market share held by M-PESA in terms of transactions.
Electricity sector: Complementing ‘competition for the market’ schemes with ‘competition in the market’ to increase sector efficiency and benefits for consumers

Kenya’s PMR score for the electricity sector is significantly higher than in other countries due to a concentrated market structure along the supply chain and barriers to consumer selection of providers. Its score is second only to Costa Rica and South Africa where power outages and high prices have highly constrained the electricity market. Due to historical reasons, the Kenya Electricity Generating Company (KenGen) has a high market share in electricity generation (around 70 percent) and Kenya Power and Lighting Company (KPLC) continues to be a monopolist in distribution and retail. Although the current legal framework—in line with international practice—allows large customers to choose their electricity supplier, in practice, they are granted no choice. This lack of choice serves to preserve the current system that entails cross-subsidization across consumer groups. There is also a lack of effective ownership separation between certain segments of the industry, with KPLC carrying out transmission and distribution as well as all retailing activities, and the government participating in both KPLC and KenGen.

Having acknowledged the reality that defines the electricity market in Kenya, the first step in a medium-term strategy is to tackle the bottleneck characterizing the upstream market and incentivize entry by other players. The government has embraced a strategy to create competition for the market by tendering generation projects included in the master plan. This will certainly reshape market structure in the generation market. Nonetheless, establishing a system based on open access or wheeling in the medium-term could facilitate entry in the upstream market, increase competitive pressure to encourage generators and KPLC to become more efficient, and allow for efficient choice by large electricity consumers. Such a system has been successfully adopted in various countries. Proposed provisions in the Energy Bill 2014 go some way towards addressing this issue to allow for some choice for large customers. In addition, the government is evaluating the implementation of a competitive system to grant Feed in Tariff (FiT) support for renewable energy generation projects; this would also ensure more efficient allocation of government resources to support renewable energy.

It is important to ensure competition in the process of tendering generation projects under the 5,000 Megawatt (MW) power plan. Technology neutral tenders favor competition and efficiency compared to a central planning approach with defined locations, technology, and size of projects. Selection by an independent panel based on transparent rules is important to avoid conflicts of interest and distortions on the level playing field. Given the predictability of the pipeline of projects and the limited number of firms in the sector, the CAK will play an important role in detecting potential anticompetitive agreements between bidders for the generation projects.

Power Purchase Agreements (PPAs) can be designed so as to promote stronger competition in the upstream market in the future. First, the duration of PPAs could be reduced to the minimum length that guarantees investors recover their costs and get a normal return on their investments. This solution, while still safeguarding and promoting investments at the upstream level, allows competition to take place in the market whenever it is viable. The PPAs would benefit from including provisions that allow for necessary future flexibility such as eliminating exclusive purchase by KPLC and permitting direct sales to customers at unregulated rates.
Professional services: Refocusing regulation to ensure quality and competitively priced services

The Kenyan economy has started to rely more heavily on professional services; however, regulations of the sector still have features that reduce incentives to compete. Kenya’s average PMR score for all professional services is higher than the average score for both OECD countries and Latin American and Caribbean countries. However, out of the four professions surveyed (accounting, legal, architecture, and engineering) engineering does not seem to raise particular regulatory concerns.

Mandatory minimum prices for professional services are still in place, affecting market signals. The impact of such price regulations should be carefully evaluated because the result is likely to be higher prices for consumers or unserved demand. There are potentially more effective and less restrictive means of ensuring that quality services are available, such as increasing transparency on service standards or increasing the information conveyed to consumers on quality. Mandatory minimum prices could initially be replaced by non-binding referential prices in a transition to full elimination of price controls.

The professional services market would benefit if constraints on advertising were eliminated. Currently, across professional services, it is prohibited to make reference to any former client. Allowing professionals to advertise their client portfolio would boost competition. This would, in fact, be a signal through which professionals could distinguish themselves and their services.

Finally, partnerships across professional services in Kenya could be allowed and encouraged. Currently, cooperation across professions is forbidden for a number of professional services. These restrictions are likely to prevent the exploitation of synergies that exist across professions. Moreover, they are likely to restrain the expansion of one-stop shops for professional services in remote areas that are not currently served.

Insurance sector: Redefining the approach to regulating the sector in order to boost access

In the insurance sector, the main regulatory obstacles identified include the limitation on foreign equity in insurance companies and approval of product-specific premiums by the Insurance Regulatory Authority (IRA). Some of these issues have been tackled in the Draft Insurance Bill 2014, but certain concerns remain. In particular, this report puts forward some recommendations on the role of IRA, which could become more effective by focusing on solvency and risk-based regulation rather than fixing the premium for each insurance product. Every insurer needs to set its own premiums and avoid potentially anticompetitive arrangements. In this light, the IRA’s proposed move towards risk-based supervision with the Draft Bill is encouraging but there is a need to expedite the planned reforms.

Further liberalization, coupled with strong supervision and regulation, is recommended to prevent collusive behavior that might spread as a result of the characteristics of the industry. Indeed, while it is vital for insurance companies to share some type of information in order to be able to assess risks for different parameters (estimate risk-based premiums), sharing other information, such as margins per product, might facilitate collusion. Competitive insurance markets serve the national interest because such an insurance market would offer businesses and individuals more choice (high quality insurance policies and services) and better value (lower prices using a risk-based approach). It is therefore essential that the regulatory environment is oriented towards increasing competition between insurers in order to promote wider access to insurance services.

Executive Summary
Air transport: Preventing restrictions on entry and expansion

Market regulations for the air transport sector in Kenya are in line with those of OECD countries, but elimination of ownership restrictions and a market-based mechanism to allocate slots could be evaluated. Analysis of this sector brought to light two characteristics of air transport regulation that might impair effective competition and become more limiting as the market develops: First, there are ownership restrictions on foreign investors in Kenya, with foreign ownership of airlines capped at 49 percent of shares. Second, if Jomo Kenyatta International Airport (JKIA) becomes more congested in the future, there may be a need to consider the implementation of clear and transparent slot allocation mechanisms which specifically bolster the competitive position of entrants vis-a-vis incumbents. In the past few months, bilateral agreements with Rwanda and Tanzania have been renegotiated, allowing for entry of Rwandan and Tanzanian carriers in the main routes from Nairobi to Uganda and Tanzania respectively, and therefore opening the market to more competition. The implementation of the EAC Common Market Protocol commitments on air transportation could allow for more intense competition on a level playing field among operators in the region.

Policy response for more effective regulations: Strengthening the competition policy framework and integrating it into the Vision 2030 agenda

A more effective competition policy framework could be achieved with the adoption of measures aimed at (i) pursuing advocacy activities to minimize anticompetitive regulation, and (ii) increasing the effectiveness of the antitrust framework and its enforcement. Such reforms would also foster a more predictable and transparent business environment.

Regulatory design, informed by competition principles, will allow the government to progressively eliminate regulations that create barriers to competition and hinder economic growth. In accordance with this principle, the Statutory Instruments Act 2013, mandates regulatory authorities to prepare a regulatory impact statement for every statutory instrument (rule, order, regulation, form, by-law, resolution, etc.) that is likely to impose significant costs on the community. The required analysis includes the impact on the private sector and the effects on competition conditions. Furthermore, the Act mandates public consultations for all the instruments that are foreseen to affect competition. Integrating the analysis of regulatory impact on competition into the cost-benefit analysis of proposed policies, bills, and regulations will be a useful action.

A key issue hindering operationalization of the Statutory Instruments Act is the absence of provisions in the Act on establishing an institutional and procedural framework for regulatory impact assessment. In particular, there is currently no provision for independent scrutiny, coordination or quality control of the regulatory impact assessment process and of the regulatory impact statements produced by the responsible agency. The development of an institutional framework for the Statutory Instruments Act, including the allocation of responsibility to an appropriate body for oversight of the process, would thus be a crucial step in integrating the analysis of regulatory impact on competition into the cost-benefit analysis of proposed policies, bills, and regulations.

Collaboration between sector regulators, subnational governments, and the Competition Authority of Kenya is essential to address existing regulatory restrictions to competition and prevent anticompetitive behavior. According to the Competition Act No.12 of 2010, the CAK has a role in studying government policies, procedures, programs, legislation, and proposals for legislation so as to assess their effects on competition and consumer welfare and also provide its opinion on them. Furthermore,
the Competition Act acknowledges the need for CAK's collaboration with other regulators to ensure consistent application of the principles of competition law. CAK has started to implement collaboration agreements with some regulators and to approach government institutions in sectors where competition enquiries have been launched or where anticompetitive practices seem to be prevalent. This advocacy work by the CAK could be strengthened through an inter-institutional platform. Guidelines prepared by the CAK for assessing the impact of regulations on competition can also be a useful instrument for national and subnational government entities interested in improving the quality of their regulatory framework.

Kenya also stands to benefit from increasing regulatory cooperation at the regional level in order to drive progress on various regional and national reforms. Regulatory cooperation with neighboring countries which have similar regulatory objectives could assist in incentivizing or accelerating the development of certain standards or the reform of licensing and permits systems. For example, ensuring compliance with the EAC Common Market Protocol in sectors such as professional services and air transport can also help to enhance cooperation in the regulation of these services at the regional level and thus encourage the implementation of reforms on, for example, advertising restrictions and minimum pricing provisions in the case of professional service and on foreign ownership in the air transport sector.

Table 1 summarizes the main recommendations highlighted in the report. The complete list of recommendations is included in Annex 1. The priority of each area of reform has been determined based on the expected impact on the Kenyan economy and its contribution to achieving Vision 2030. Where implementation would be undertaken at the international or regional level this is specifically indicated in the table, otherwise it should be assumed that implementation would be at the national level.
Table 1: Main Recommendations to Unlock Regulatory Restrictions That Limit Competition in Kenya

<table>
<thead>
<tr>
<th>Topic/sector</th>
<th>Subtopic / subsector</th>
<th>Competition restrictions on</th>
<th>Recommendations</th>
<th>Implementing bodies</th>
<th>Priority</th>
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</thead>
</table>
| State participation in markets | State-owned enterprises and price controls | Entry and Level playing field | • Review the economic outcomes of state participation in commercial activities (including impact on private sector) and establish guidelines on when the GoK should engage in commercial activities or phase out.  
• Approve a legal framework that defines the conditions under which county corporations might be established.  
• Review indirect price controls in agriculture through subsidies and influence of state-owned companies on prices. | Ministry of Finance, sectoral ministries, Council of Governors | High     |
| Licensing system        | Regulatory quality and burdens on start-ups | X X                         | • Continue implementation of an overarching program across sectors and counties targeted at simplifying rules and procedures, as well as rationalizing licensing and permits systems.  
• Reduce administrative burdens on start-ups including corporations and sole proprietor firms. | Ministry of Industrialization and Enterprise Development, Council of Governors | High     |
| Trade and treatment of foreigners | Barriers to trade in services and goods | X X                         | • Reduce NTBs and resolve NTBs that obstruct the implementation of the EAC Common Market Protocol (to be implemented at national level with regulatory cooperation at the regional level).  
• Eliminate regulations that contain differential treatment of foreign suppliers in professional services and public procurement. Evaluate the level of import tariffs for goods, particularly in agriculture. | Ministry of Foreign Affairs and International Trade, sectoral ministries, Public Procurement Oversight Authority | Medium   |
| Pro-competitive regulations | Advocacy                                | X X X X                      | • Ensure operationalization of the Statutory Instruments Act 2013 through an appropriate institutional and procedural framework. Consider allocating oversight responsibility to an independent body.  
• Implement mechanisms to integrate the analysis of regulatory impact on markets and competition in the design of policies and regulations based on the Statutory Instruments Act and the Competition Act.  
• Use market inquiries under the Competition Act to periodically review regulations in key sectors to achieve Vision 2030 and execute flagship projects. | Parliament, Ministry of Industrialization and Enterprise Development, Ministry of Finance, Competition Authority of Kenya (CAK) | High     |

Key areas to tackle restrictive, economy-wide product market regulations and ensure a level playing field among firms.
<table>
<thead>
<tr>
<th>Topic/sector</th>
<th>Subtopic / subsector</th>
<th>Competition restrictions on</th>
<th>Recommendations</th>
<th>Implementing bodies</th>
<th>Priority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>Staple grains</td>
<td>X X</td>
<td>• Reduce government involvement in markets through the NCPB, and maintain impetus in the reform of NCPB to separate its commercial functions</td>
<td>Ministry of Agriculture, Livestock and Fisheries; CAK (reform advocate)</td>
<td>High</td>
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<td></td>
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<td>• Evaluate other market-oriented measures (commodity exchange platform, futures market, warehouse receipt system)</td>
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<td></td>
<td>Tea</td>
<td>X X</td>
<td>• Review the regulatory framework, including the Tea Act, the draft Tea Regulations and the draft National Tea Policy, to remove unnecessary requirements for factory licensing, and ensure proper implementation under the AFFA Tea Directorate</td>
<td>Ministry of Agriculture, Livestock and Fisheries; Agriculture, Fisheries and Food Authority; CAK (reform advocate)</td>
<td>Medium</td>
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<td></td>
<td></td>
<td></td>
<td>• Ensure that licensing decisions are market driven rather than determined by incumbents</td>
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<td>• Review regulations which lock in growers with factories for an undetermined period of time.</td>
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<td></td>
<td>Sugar</td>
<td>X X</td>
<td>• Reduce trade barriers (import quotas, import permits and non-tariff barriers)</td>
<td>Ministry of Agriculture, Livestock and Fisheries; Agriculture, Fisheries and Food Authority; CAK (reform advocate)</td>
<td>Medium</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>• Evaluate reduction of government ownership to increase efficiency in the sector</td>
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<td></td>
<td>Fertilizers</td>
<td></td>
<td>• Remove reliance on the NCPB for subsidized fertilizer</td>
<td>Ministry of Agriculture, Livestock and Fisheries; CAK (reform advocate)</td>
<td>High</td>
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<td></td>
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<td>• Evaluate mechanisms such as a voucher system, whereby farmers can procure fertilizer at a subsidized rate from various competing firms</td>
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<tr>
<td></td>
<td>Seeds</td>
<td>X X X X</td>
<td>• Increase openness and transparency of government tenders for licensing new seed varieties developed by the government</td>
<td>Ministry of Agriculture, Livestock and Fisheries; Kenya Plant Health Inspectorate Services; Kenya Agricultural Research Institute; CAK (reform advocate)</td>
<td>Medium</td>
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<td></td>
<td></td>
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<td>• Ensure competitive neutrality among private and seed companies with state participation</td>
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<td></td>
<td>• Consider the introduction of a voucher coupon system for maize seed supply as an alternative to subsidies through NCPB</td>
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<td></td>
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<td></td>
<td>• Update the regulatory framework in the seed sector to facilitate private participation and encourage production of quality seed</td>
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<tr>
<td>Electronic communications</td>
<td>Mobile telecom</td>
<td>X</td>
<td>• Reassess the level of porting fees</td>
<td>Communications Authority of Kenya (CA)</td>
<td>Medium</td>
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<td></td>
<td></td>
<td></td>
<td>• Automate the procedure for number portability</td>
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<td></td>
<td>Spectrum allocation</td>
<td>X X</td>
<td>• Establish market-based rules to assign spectrum and prevent distortions in the competitive environment</td>
<td>Ministry of Communications Information Technology; Communications Authority of Kenya; CAK (reform advocate)</td>
<td>High</td>
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<td>• Ensure the PPP framework for social and infrastructure projects does not distort the level playing field</td>
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<td></td>
<td></td>
<td></td>
<td>• Facilitate collaboration between CA and CAK to ensure competition in assigning mobile spectrum</td>
<td></td>
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<tr>
<td>Topic/sector</td>
<td>Subtopic / subsector</td>
<td>Entry</td>
<td>Level</td>
<td>Strategies</td>
<td>Business</td>
</tr>
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</tr>
</tbody>
</table>
| Mobile payment system |                                                                                      | X     |       |            |          | X        | • Develop mechanisms to promote interoperability between operators  
• Ensure elimination of exclusive contracts between mobile payments providers and merchants  
• Assess options to facilitate third party access to USSD channels or SIM cards  
| Electricity | Generation                                                                          | X     |       |            |          | X        | • Ensure competitive neutrality between KenGen and other investors in generation  
• Guarantee a transparent selection process under the 5,000 MW program and monitor the process to prevent anticompetitive practices  
• Evaluate the conditions and length of PPAs to facilitate competition in the medium-term  
• Pass and implement the Energy Bill 2014 to allow large customers to choose their supplier in the medium-term while mitigating effects on the current subsidy scheme across customer groups  
| Professional Services | Legal and architectural services in particular                                          | X     |       |            |          | X        | • Minimize restriction on entry of foreigners in compliance with the EAC Common Market Protocol (to be implemented at the national level with regulatory cooperation at the regional level)  
• Eliminate minimum fees for professional services (legal and architecture services)  
• Eliminate constraints on advertising practices (all four services)  
| Insurance | Insurance and brokerage services                                                     | X     |       |            |          |          | • Effectively transform the regulatory approach from per-product premium regulation to risk-based regulation based on solvency indicators, and allow insurance companies to set their premiums independently  
• Remove limitations on foreign equity participation as established in the Insurance Bill 2014  
• Facilitate collaboration between CA and IRA to prevent anticompetitive practices  
| Air Transport | Passenger transportation                                                             | X     |       |            |          |          | • Evaluate minimizing restrictions on foreign ownership  
• Establish a clear slot allocation procedure to increase predictability in case of congestion and ensure competitive neutrality  
|                                                                                          |     |       |            |          |          | **Regional Level Implementation**  
• Support the implementation of the EAC Common Market Protocol to increase competition in regional air transport routes  
|                                                                                          |     |       |            |          |          |                                                                                                                                  | Ministry of Transport and Infrastructure; Kenya Civil Aviation Authority; CAK (advocate) | Medium              |

**Executive Summary**

Mobile payments:
- Develop mechanisms to promote interoperability between operators.
- Ensure elimination of exclusive contracts between mobile payments providers and merchants.
- Assess options to facilitate third party access to USSD channels or SIM cards.

Electricity:
- Ensure competitive neutrality between KenGen and other investors in generation.
- Guarantee a transparent selection process under the 5,000 MW program and monitor the process to prevent anticompetitive practices.
- Evaluate the conditions and length of PPAs to facilitate competition in the medium-term.
- Pass and implement the Energy Bill 2014 to allow large customers to choose their supplier in the medium-term while mitigating effects on the current subsidy scheme across customer groups.

Professional Services:
- Minimize restriction on entry of foreigners in compliance with the EAC Common Market Protocol (to be implemented at the national level with regulatory cooperation at the regional level).
- Eliminate minimum fees for professional services (legal and architecture services).
- Eliminate constraints on advertising practices (all four services).

Insurance:
- Effectively transform the regulatory approach from per-product premium regulation to risk-based regulation based on solvency indicators, and allow insurance companies to set their premiums independently.
- Remove limitations on foreign equity participation as established in the Insurance Bill 2014.
- Facilitate collaboration between CA and IRA to prevent anticompetitive practices.

Air Transport:
- Evaluate minimizing restrictions on foreign ownership.
- Establish a clear slot allocation procedure to increase predictability in case of congestion and ensure competitive neutrality.
- Support the implementation of the EAC Common Market Protocol to increase competition in regional air transport routes.
Kenya’s business environment has been weakening over recent years and this has limited the private sector’s ability to grow, create jobs, and contribute to economic development. In the 2015 World Bank Doing Business Report, Kenya ranked 136th out of 189 countries, a 58 country drop from 2008 (and top global reformer status). Although there have been improvements in terms of specific doing business indicators, Kenya ranks 108th out of 189 economies according to the 2016 Doing Business Report. Furthermore, a report by the African Development Bank (2013) on the state of Kenya’s private sector observes that while the country is a promising place to do business, the private sector faces recurrent challenges that prevent it from reaching its full potential.

Ensuring competitive local markets can enable Kenya to achieve its Vision 2030 objective to attain middle income status by 2030. Competitive domestic markets are necessary to boost Kenya’s competitiveness for a number of reasons: First, firms that operate in more competitive markets are more efficient and innovative; hence their products can compete in the international market. Studies find a positive relationship between competition (measured by lower domestic concentration) and export intensity. Firms competing in open, contestable markets are more productive and therefore more likely to export. Second, anticompetitive practices and restrictive product market regulations increase the cost of intermediate services and products (such as electricity, telecommunications, and agriculture inputs), hampering country competitiveness in global markets. Finally, setting clear regulatory frameworks that encourage firms to compete will also help to achieve goals of poverty reduction and shared prosperity. Effective competition policies, through pro-competitive regulatory frameworks and effective competition law enforcement, will ensure redistribution of rewards to the poor as consumers, producers and workers.

There are two pillars that sustain effective competition policy: opening markets and removing anticompetitive regulation, and effectively enforcing competition law. An effective competition policy framework encourages competition by ensuring that all businesses can interact on a level playing field and by facilitating entry to markets, while penalizing anticompetitive behavior. In practical terms, competition policy usually involves the enforcement of antitrust laws (typically rules against abuse of dominance, anticompetitive agreements, and merger control) and the promotion of measures to enable firm entry and rivalry, typically referred to as competition advocacy. The Competition Act 2010 has significantly strengthened the antitrust framework in Kenya but there some areas that still need to be updated to improve the effectiveness of the framework (Box 1). An equally important component of a successful competition policy is ensuring that government policies and regulations do not generate unnecessary barriers to entry or distort the playing field by favoring specific firms. This pillar lies at the heart of this report.

The main focus of this report is the identification of regulations that could restrict competition and distort markets and business decisions, having a negative effect on Kenya’s competitiveness and growth. This report contains results from a review of the regulatory framework in key areas identified using OECD’s Product Market Regulation (PMR) indicators, the World Bank Group’s framework to identify anticompetitive regulations, and interviews with stakeholders. This report is concerned only with certain regulations that affect market competition in select sectors and topical areas.
Unlocking Growth Potential in Kenya

This initiative falls within the scope of the Kenya Investment Climate Program carried out by IFC, World Bank Group, in partnership with DFID and various institutions of the Kenyan government. The program aims to improve the regulatory framework in order to facilitate investment and increase Kenya’s competitiveness, and promoting competition is an important pillar of the program. The report was prepared at request of the Competition Authority of Kenya that, according to the Competition Act 2010, has a role in studying government policies, procedures, programs, legislation and proposals for legislation so as to assess their effects on competition and consumer welfare.

This report stems from the policy dialogue with various Kenyan institutions, supported by the Kenya Investment Climate Program. In addition, it benefitted from a fact-finding mission carried out from May 12–16, 2014 that included interviews with stakeholders from the public and private sector, as well as civil society, and from a validation workshop with public and

**BOX 1: KENYA’S COMPETITION ENFORCEMENT FRAMEWORK**

Kenya has made significant progress in strengthening its competition enforcement framework to enable the Competition Authority of Kenya (CAK) to promote competition and to protect consumers from anticompetitive market conduct and potentially harmful mergers. An important step in this direction was the enactment of the Competition Act 2010, which came into effect in August 2011 and established the CAK as an independent body, whose principal functions include applying, promoting and enforcing compliance with the Act. It also established the Competition Tribunal which hears appeals against decisions of the Authority. The Act contains provisions covering restrictive trade practices (including agreements and abuse of dominance), mergers, and control of unwarranted concentration of economic power. The CAK currently operates with around 33 technical staff and, in the last two years, has concluded four cases relating to restrictive trade practices, reviewed 178 mergers, and provided several advisory opinions.

Recent amendments to the Competition Act through the enactment of the Finance Act, 2014 went some way towards addressing a number of outstanding issues in the competition law framework. Amongst the amendments were provisions to allow for the development of a leniency program, whereby firms could be incentivized to disclose cartel behavior or to cooperate with a CAK investigation in exchange for being granted reductions on fines that are set out by the Act. The amendments also mandate all professional associations to apply for exemptions to horizontal agreements in case their rules could amount to a restrictive trade practice. The CAK has published various guidelines on restrictive trade practices and mergers to increase the transparency and predictability of the legal framework. The CAK has also recently launched an anti-cartel compliance program for business associations - initially targeting financial and agribusiness sectors - to encourage compliance with the law and eliminate horizontal agreements.

Despite these advancements, there remain areas which could be addressed in order to improve competition enforcement. The most important amendment is raising sanctions to enhance their deterrent effect. Fines are currently capped at KSH 10 million for restrictive trade practices, particularly horizontal agreements, regardless of the size of the firm involved or the nature of the offence. A common international practice is to the set the maximum fine at 10 percent of the turnover of the firm involved. Furthermore, since it is currently a criminal offence to engage in prohibited restrictive practices, it is recommended that it should be clarified precisely which practices are offences and who will be subject to pecuniary sanctions versus imprisonment. This is especially important since criminalization would impact on the leniency program.
private sector stakeholders held in February 2015. Previous sectoral reports and economic analysis on the Kenya regulatory framework and international good practices on competition policy have also informed this report. Product Market Regulations indicators calculated by OECD in collaboration with the World Bank Group were used in the analysis.

The report contains three parts. Part I identifies restrictive regulations that affect the whole economy, while Part II focuses on select sectors. Part III provides policy recommendations to promote greater competition in Kenyan markets through the assessment and modification of regulations that create obstacles to competition. Part III also provides estimates of the potential benefits of reforming product market regulations.
1.1 HOW OVERLY RESTRICTIVE REGULATIONS IMPAIR THE KENYAN ECONOMY

Well-functioning markets are crucial to attaining economic growth, job creation, and prosperity. Competition is widely recognized as an essential element to improve the economic performance of any sector. In some cases, regulation may be beneficial at a point in time and for a specific situation; however, it may end up lasting too long and becoming overly protective of the status quo, restricting competition rather than promoting it. Economic theory shows that enhanced competition is likely to increase the productivity of firms (Aghion and Griffith, 2008, and Acemoglu et al, 2007). Empirical evidence, moreover, supports the theoretical findings and proves that competition enhancing policies can contribute positively to productivity growth (Buccirossi et al., 2013), or increases the incentive of firms to innovate (Bassanini and Ernst, 2002). A more competitive business environment will ultimately benefit consumers through lower prices and wider choice.

In contrast, maintaining restrictive regulations in key sectors is likely to cause Kenya to lag behind other economies, limiting access to otherwise competitive markets, and unnecessarily constraining business operation. It has been estimated that reducing anticompetitive regulation to best practice levels would result in productivity gains of between 3 and 13 percent over a period of seven years (Bourlès et al., 2010). Similarly, empirical work shows that the faster countries restore competition in the markets, especially in key sectors, the quicker they can converge to the best practice productivity growth rate (Conway and Nicoletti, 2007). For this reason, this report is aimed at pinpointing potential regulatory constraints, and putting forward some recommendations on how to reduce those barriers to competition in order to allow Kenya to reduce its regulatory burden and reach the best practice level.

There is a negative correlation between overly restrictive regulation and productivity, proven by empirical evidence from other jurisdictions. Arnold et al. (2011) have analyzed data from OECD countries and found that the use of regulation has been very different across countries and this has had an impact on resource allocation and productivity outcomes. In particular, they show that countries where regulatory burdens are lower have, in general, the highest GDP per capita and productivity growth rates. Moreover, where regulatory pressure is lower, competitive forces can work freely and reallocate resources towards the highest-productivity firms.

Regulations can also affect productivity growth by protecting the least efficient firms from competition. Anticompetitive regulations distort the way in which resources are allocated and reduce the level of competition in the market. This means that inefficient firms are able to remain in the market at the expense of more efficient competitors or new entrants. In contrast, economic theory shows how competition

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14 In Bourles et al. (2010) they estimated Multifactor Productivity gains in the non-farm business sector in 2007. They did this by adopting the best practice level regulations from the year 2000 and used them to estimate the productivity gains for 20 sectors in 15 OECD countries. The highest potential gains were observed in the retail trade and professional services sectors.
increases net welfare by improving allocative efficiency. For this reason, when competition is restored in the market, it is common that firms fail and exit the market. This is because competition leads to higher firm turnover whereby inefficient firms will leave the market, while more efficient ones will be able to enter the market. It logically follows that markets that are more competitive are more mobile; thus, firms’ failure should not be seen as negative for the economy.\(^\text{15}\)

1.2 KEY ELEMENTS FOR A PRO-COMPETITION ASSESSMENT OF THE REGULATORY FRAMEWORK AND DEVELOPMENT OF PRO-COMPETITIVE ALTERNATIVES

Regulations are defined as those rules, normally overseen by the government, that seek to influence the behavior of businesses and eventually affect the economy. This definition encompasses a wide range of rules including regulations enacted by governments, standards set by sector regulators, and limitations imposed by professional organizations. Such rules are often driven by social and economic motives; however, these may also impair competition and harm welfare. In some cases, the lobbying power of the main players in the market might influence rule setters; this phenomenon is defined in the literature as the regulatory capture.\(^\text{16}\)

There are a number of reasons explaining why governments adopt regulatory tools to intervene in the markets: one essential motive is economic. In particular, rules might be needed in order to address market failures. Governments aiming at protecting public policy goals can use regulatory instruments so as to control monopoly power or externalities negatively affecting consumers. This may occur when market forces alone do not lead to the socially optimal outcome, for instance, in the presence of the following factors:

- Natural monopolies arising from high fixed costs that can be sustained only by achieving large economies of scale (that is the case of most utility sectors, where a large upfront investment is needed in order to build the network system).
- Negative externalities that generate high social costs (such as pollution in the manufacturing industry).
- Health and safety risks (indeed, limitations due to health reasons are very common in the pharmaceutical industry and the food industry, while safety rules are in place in most of the work places).
- Potential risks to the economy's stability (for instance, governments worldwide, especially after the 2007 economic downturn, heavily intervened in the financial sectors with the aim of preserving the financial stability by requiring a higher cash reserve ratio).
- Information asymmetries on the quality or other characteristics of the service or goods provided, or on the characteristics of the buyers (for example, credence goods such as professional services, or moral hazard or adverse selection issues such as those arising in the credit and insurance sector).

Whilst regulations can often be economically justified and are important and necessary tools for policy-makers in achieving policy objectives, they also have the potential to restrict market competition to varying degrees. This reduction in competition is a particularly important cost affecting the private sector, consumers and the economy as a whole. It is therefore important for policy makers to objectively justify the costs of such an impact relative to the benefits, or to seek less costly alternatives. This will allow policy makers to create better regulation and maximize its positive impact.

\(^{15}\) For more details on benefits arising from increased competition in the developing world, see World Bank (2004), and Cook (2007).

\(^{16}\) The notion of regulatory capture was first theorised by the Chicago School (see Stigler, 1971), and further developed by the Toulouse School (see Laffont and Tirole, 1991).
When assessing the effect of regulations on market competition, product market regulations may be classified into four main groups, according to their impact on the way current and potential operators compete:

- **Regulations that alter the entry conditions in a market.** These may be absolute limits (such as exclusive rights for a supplier to provide goods or services), or regulations that make the entry of a new player more costly and might discourage entry in the first place. Such rules may take the form of general restrictions (e.g., if membership in a professional organization is compulsory in order to legally practice a professional service), or specific restrictions (e.g., crop variety registration requires very strict variety testing requirements). Entry of new players may also be prevented by rules that limit access to input or distribution channels, as well as through minimum distance between outlets or processing facilities.

- **Rules that create discriminatory conditions among players.** Subsidies or incentive policies, if not properly designed, might alter the level playing field. In addition, the presence of enterprises with government ownership in the market might put private competitors at a competitive disadvantage if those parastatals benefit from exclusivity rights, access to government land and other resources, subsidies, loans, and more favorable conditions when complying with regulations. These types of rules also comprise regulations that set forth explicit discriminatory treatment among market entrants, or discriminate against a given type of service provider (foreigners, small companies, new players, among others). These regulations award discretionary decision powers to authorities and may result in discriminatory treatment. For instance, some regulations fail to lay down objective requirements for awarding licenses or creating oversight mechanisms, thereby providing unlimited powers to decide on suspension of business operations and other similar measures. Such regulations prevent effective oversight of authorities’ performance and may therefore create fertile ground for granting unwarranted preferential treatment to certain players. In turn, this may result in discriminatory treatment among companies competing in the same market and create a culture medium for corruption.

- **Regulations that limit businesses strategy options.** Rules that impose constraints on the players’ pricing decisions (such as price ceilings or price floors), or that affect other business choices, such as advertising, opening hours or quality, can have significant anticompetitive impacts. Government regulations can also indirectly reduce firms’ incentives to adopt competitive strategies; for instance, by encouraging business associations to share information in a way that facilitates cartels, encouraging them to negotiate price conditions under government monitoring, or by establishing pricing guidelines. Regulations can also limit the seller’s ability to choose buyers, for example, when single buyers are established.

- **Rules that limit consumers’ ability to choose.** A regulation may confine consumers to purchasing some services in a given area or from given suppliers. This gives suppliers monopoly power over that set of consumers. Regulations can make consumers more or less willing to switch suppliers by affecting “switching costs” which are the (direct or indirect) costs that consumers have to bear if they want to switch from one supplier to another. For instance, this is the case of rules limiting number portability in telephony markets; these are likely to increase switching costs for consumers wanting to change to a different operator. Lack of transparency of purchasing conditions also reduce the ability of consumers to compare products among sellers and choose.
Whatever the economic justification for a regulation and whatever category of restriction it falls under, assessing current regulations means understanding what that particular rule is seeking to achieve, and then evaluating whether there are less restrictive policy options that can achieve the same policy objective. In practice, each policy goal will match with a large number of possible regulatory approaches. Because of the complexities that will inevitably characterize each individual case, it is impossible to create a definitive match between current regulation and solutions. However, there are guiding principles that can be applied across cases:\(^{17}\)

- The most appropriate solution is the alternative that, among those that address the underlying policy objective(s), minimizes the resulting competitive restraints or market distortions.
- Market-oriented and incentive-based approaches that support compliance are generally preferable to direct controls.
- Standards/regulation targeting performance or outcome is generally preferable to those targeting design of production methods or input usage.
- Where market failures arise from inadequate or asymmetric information, remedies which increase the amount of information available between suppliers and buyers present the most effective means of correcting the failure.\(^{18}\)
- It is often more efficient to tackle market failures in the activity in which they occur rather than introducing additional restraints on competition in another sub-sector of the market.

1.3 ECONOMY-WIDE ANALYSIS

Although the Kenyan economic outlook appears weak, some indicators show that there are still many unexploited areas of development. According to the Global Competitiveness Report 2013-2014,\(^ {19}\) Kenya is in the first stage of development, the factor-driven stage.\(^ {20}\) The country has a score of 3.8 points (out of 7) in the Global Competitiveness Index, ranking 96\(^ {\text{th}}\) among the 148 countries surveyed. However, compared to the other factor-driven economies, Kenya outperforms them along most of the dimensions analyzed.

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\(^{17}\) Annex 6 provides an example of a set of questions and issues applied to the case of strict licensing requirements that can be used by policy-makers to optimize regulatory design or identify appropriate pro-competitive alternatives. Further guidance on identifying the most appropriate suitable alternative regulatory and non-regulatory measures that remove, or at least reduce, potential anticompetitive distortions are laid out in the forthcoming Guidelines on the Assessment of Regulatory Impact on Competition prepared by the Competition Authority of Kenya. It is worth noting that the outlined principles and best practices outlined are consistent with other existing tools and checklists. For example, the OECD market openness principles are intended to be built into the domestic regulatory process to ensure that domestic regulations, procedures and administrative practices are in line with trade and investment openness.

\(^{18}\) It should be noted, however, that caution should be exercised in facilitating information exchange amongst competitors since this has the potential to facilitate collusion. In particular, information exchange of disaggregated/firm-level information on future variables should be avoided.

\(^{19}\) Available at http://www.weforum.org/reports/global-competitiveness-report-2013-2014

\(^{20}\) Two criteria are used to allocate countries into stages of development: (i) GDP per capita at market exchange rate; and (ii) share of exports of mineral good in total exports. Countries that export more than 70 percent mineral products (measured using five-year average) are considered factor-driven. Moreover, stages of development are dictated only by income for countries that export less than 70 percent minerals (World Economic Forum, 2013). According to World Economic Forum (2013), the following are factor-driven countries (stage one of development): Bangladesh, Benin, Burkina Faso, Burundi, Cambodia, Cameroon, Chad, Cote d’Ivoire, Ethiopia, Gambia, Ghana, Guinea, Haiti, India, Kenya, Kyrgyz Republic, Lao PDR, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Myanmar, Nepal, Nicaragua, Nigeria, Pakistan, Rwanda, Senegal, Sierra Leone, Tanzania, Uganda, Vietnam, Yemen, Zambia, Zimbabwe.
On the one hand, Kenya has improved growth prospects. Kenya is one of the top 10 countries in Sub-Saharan Africa according to the overall Global Competitiveness Index, revealing a great growth potential. The economy is estimated to have grown 5.4 percent in 2014. The World Bank projects that Kenya’s GDP will grow 6 percent in 2015, 6.6 percent in 2016, and 7 percent in 2017. In addition, the most recent Global Competitiveness Report revealed that Kenya is one of the regional leaders in terms of effectiveness of antimonopoly policy (ranking 50th out of 148), limited extent of market dominance (ranking 60th), and intensity of local competition (ranking 35th), while most of the Sub-Saharan countries rank among the bottom 40 countries along those three dimensions (World Economic Forum, 2013).

21 OECD 2013, Schemata.
22 World Bank (2014).
On the other hand, the review of the current status of the overall regulatory framework on markets in Kenya shows that there is room for improvement. The methodology of economy-wide PMR (see Box 3 for a methodological reference) is a useful instrument for pinpointing rules that are likely to exercise restrictive pressure on competition. It should be kept in mind that PMR analysis is not an end in itself: once scores are calculated, these must be used as a screening device to identify the aspects of the regulatory framework that are more likely to have a negative impact on competition. As a caveat to the following sections, it is important to underline that for comparability purposes, the Kenyan regulatory framework will often be compared to that of countries for which PMR scores have been computed – i.e., the OECD, BRICS and Latin American and the Caribbean (LAC) countries. Such a comparison is not intended to give insights on the merits of regulatory set-up as different economic, social and political factors are likely to play a role in this sense. Instead, it is exclusively intended as an exercise for better understanding the regulatory framework and potential regulatory obstacles to competition present in Kenya.

According to the PMR indicators, amongst the set of countries for which indicator values are available, regulatory restrictions to competition are more limiting in Kenya than in middle-income countries (BRICS countries, Latin American and the Caribbean countries, and other middle income countries such as Turkey, Romania and Bulgaria) and OECD countries. Relatively, Kenya scores unfavorably when considering the economy-wide PMR score, with only China, India and Honduras scoring higher (Figure 2). Whilst Kenya’s score is in line with the average score of the BRICS countries, it is higher when compared to the average score of LAC countries, and higher than the average score of OECD countries and the European Union average.

A decomposition of the economy-wide PMR score shows that Kenya’s standing in the PMR indicators is influenced equally by high state influence in economic activities and barriers to entrepreneurship (barriers to entry and rivalry). Whilst Kenya’s score for Barriers to Trade and Investment is relatively lower than for the other components, it is important to remember that all three components are interlinked and that without regulatory reforms to reduce barriers to

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**Figure 2: Economy-Wide PMR Score**

(Scale is 0–6, from least to most restrictive of competition)

<table>
<thead>
<tr>
<th>Country</th>
<th>Score (0.6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Peru</td>
<td>3.50</td>
</tr>
<tr>
<td>El Salvador</td>
<td>3.00</td>
</tr>
<tr>
<td>Mexico</td>
<td>2.50</td>
</tr>
<tr>
<td>Chile</td>
<td>2.00</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>1.50</td>
</tr>
<tr>
<td>China</td>
<td>1.00</td>
</tr>
<tr>
<td>India</td>
<td>0.50</td>
</tr>
<tr>
<td>Japan</td>
<td>0.00</td>
</tr>
</tbody>
</table>


Note: BTI stands for Barriers to Trade and Investment, and BTE, for Barriers to Entrepreneurship.

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23 Throughout this report, Latin American and Caribbean Countries (LAC) include the following ten countries: Argentina, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Honduras, Jamaica, Nicaragua, and Peru. It does not include Brazil.

24 Best practice includes top 5 performers.
entrepreneurship and restrictions to competition caused by state influence, the gains from relatively open trade and investment regimes may not reach their full potential. For example, a number of studies provide evidence that competition in domestic markets is key for trade liberalization to have a positive distributional impact in terms of the benefits accruing to domestic producers (Sexton et al. 2007) and the relative wages of less-skilled workers (Borjas and Ramey 1995).

**State influence in markets through rules that directly affect market outcomes and participation in commercial activities is higher in Kenya compared to other countries.** Kenya performs in the lower end of the sample for the state control indicator (Figure 3). Typically, governments can influence markets either through direct participation (as a market maker or as a buyer or supplier of goods and services) or through indirect participation in private markets (through regulation, subsidies, or taxation). While the degree of state involvement in markets is the prerogative of each country, it is good practice to limit state involvement to the extent needed to address specific market failures and only when the benefits of such intervention are greater than the costs. Reviewing the economic outcomes of the broad spectrum of state interventions in Kenya is therefore important to balance policy objectives and their effects on the functioning of markets and the sustainability of growth.

State involvement in business operations and public ownership is a decreasing trend in Kenya and the regulatory framework is expected to be enhanced to rationalize government involvement in commercial activities. The Government of Kenya (GoK) has recently undertaken a process to adjust regulations on state corporations— for example, by ensuring that they are for profit. A further step in this direction could involve the establishment of guidelines on when the GoK should engage in commercial activities or, to the contrary, phase out. Counties are also eager to establish corporations and the Government Owned Entities Bill (2014) defines the conditions under which county corporations might be established. For example, Section 9 of the Bill provides that “where a county executive committee member intends to establish a county corporation or a subsidiary of a county corporation, the Committee member shall submit to the County Treasury, a written request

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***Figure 3: State Control PMR Score***  
(Scale is 0–6, from least to most restrictive of competition)

![Figure 3: State Control PMR Score](image)


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25 As defined in the PMR methodology, state control includes aspects such as public ownership, scope of public enterprise, government involvement in network sectors, direct control over business enterprises, price controls, and use of command and regulations.
for the proposed establishment. The county Treasury shall, within ninety days after receipt of the request, conduct or cause to be conducted a feasibility assessment for the purpose of ascertaining: (a) the economic viability of establishing the proposed corporation; (b) the practicability of the functions of the proposed corporation being carried out by an existing county corporation; and (c) whether or not there is need to establish a new county corporation”.

Nonetheless, Kenya still currently registers a high score on the extent of public ownership. Public ownership is calculated as a weighted average of sub-indicators of the PMR index which include scope of state owned enterprises (SOEs), government involvement in network sector, direct control over business enterprises, and governance of state-owned enterprises. Kenya registers relatively high PMR scores in all these subcategories with the exception of direct control over business enterprises. This translates into a public ownership score that is higher than the averages of OECD, LAC and BRICS countries.

In Kenya, the number of subsectors with a presence of state owned enterprises (SOEs) is relatively high and includes sectors where private participation is possible and economically viable. In Kenya, 19 sectors are characterized by the presence of SOEs\(^{26}\) (Figure 4), while the OECD average for this indicator is 13. Table 6 in Annex II specifies those sectors where SOEs are present and where the state maintains partial ownership on firms. The presence of SOEs in infrastructure sectors is not unusual in many economies, especially in sectors that require intensive capital investments (such as electricity transmission and road infrastructure). However, Kenya has SOEs in other sectors (including banking, wholesale and retail trading, and agro-processing), which in many other countries tend to be more open to private companies.

State participation in commercial activities and competition with the private sector requires special attention given its potential negative effects on attracting investment. Although the Kenyan government may have other objectives...

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\(^{26}\) According to the PMR, an SOE is defined as a company in which state or provincial governments (not including local governments or municipalities) hold, either directly or indirectly through a government-controlled company, the largest single share of the firm’s equity capital. Public ownership is measured by the extent to which the government participates and intervenes in markets through the scope and scale of its SOEs. Publicly controlled firms also include government entities that are not organized as companies, but operate in business or market activities.
(for example, boosting job creation, reducing inequality in income and asset ownership, or mitigating risks born by farmers), value-for-money principles can be applied to compare the benefits of state ownership with the cost of impairing economic efficiency, productivity growth, and fiscal sustainability. Furthermore, alternative instruments could be used to achieve the government objectives at a lower cost. SOEs do not always operate on a level playing field with the private sector and end up crowding out efficient private investment. SOEs could also enjoy preferential treatment in terms of access to public properties and natural resources which are essential for their competitors. They sometimes also enjoy certain advantages in terms of regulatory enforcement (for instance, regarding licenses, regulatory fees, and taxes) or access to financial resources and subsidies. On the other hand, SOEs could suffer from bloated workforces, cumbersome procurement requirements applicable to public enterprises, and constant political interference, reducing the efficiency of their operations and the benefits for consumers. 

Although the government aims at reducing direct participation in markets, state involvement in business operations is still higher in Kenya. Involvement in business operations is calculated as a weighted average of price controls and command and control regulations (use of coercive, as opposed to incentive-based regulations), which are both sub-indicators of the PMR index. State involvement attenuates the ability of market players to compete, restraining the range of market strategies available to participants. The price control indicator is particularly prominent: only Honduras, Russia, Turkey and Costa Rica have a higher score (Figure 5). Taking a sectoral view, considering price controls on retail distribution, Kenya’s score is in line with the OECD average. Nevertheless, the major differences come from government influence on prices in agriculture, price regulations in professional services, and the characteristics of price regulation in electricity and water. Box 4 explores how price controls can harm rather than benefit consumers. Part II of the report will explore these kinds of regulations, sector by sector.

Figure 5: Price Control Subindicator PMR Score
(Scale is 0–6, from least to most restrictive of competition)

![Price Control Subindicator PMR Score](chart)


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1. Economy-Wide Regulatory Obstacles to Competition

BOX 3: PRICE CONTROLS IN KENYA

Among the possible regulatory tools instituted by governments, there are price control rules that are often adopted in traditional monopoly sectors such as utilities (e.g., water and electricity distribution), with the aim of protecting consumers from excessively high prices. Economic theory suggests, however, that in most cases the negative effects of such policies outweigh the benefits. In general terms, there will be an inefficient allocation of resources and high costs for governments to sustain the policy and to tackle the economic consequences. The sections below will shed some light on the two types of price control: price ceilings and price floors.

Price ceiling

In Kenya, the 2011 Price Control Act lays down the following in Article 2(1):

The Minister may, from time to time, by order in the Gazette, declare any goods to be essential commodities for the purposes of this Act and determine the maximum prices of the commodities in consultation with the industry. (Emphasis added)

This provision entails what economic theory calls price ceilings. The government may be willing to set price ceilings, which prevent prices from exceeding a certain maximum, for those goods and services that are believed to be sold at a price that is excessive. However, the policy might generate counterproductive effects. Indeed, when the ceiling is placed below the price that would otherwise arise in the market under normal competitive conditions, then there would be a lack of supply or excess demand. That is, producers will not produce as much at the lower price, while consumers will demand more because the goods are cheaper. Therefore, this type of price policy, very common in the agriculture sector as well as in the utilities, might lead to reduced production that would harm consumers rather than be beneficial to them. Moreover, those producers who are willing to differentiate their products, offering higher quality or more innovative goods, are discouraged to do so as they will not be able to charge higher prices to cover for the higher costs. In addition, price ceilings present a further drawback: The price set as price ceiling by the government is likely to become the focal price. Therefore, low-cost producers that would be willing to charge a lower price and serve the most price sensitive part of the demand will nevertheless charge the price at the ceiling level, thereby harming consumers as well as competition in the market.

In Kenya, the price ceiling provision neither specifies extreme situations when the Act should be applied (for instance, crisis situations, major imbalance between demand and supply, and obvious market malfunctioning) nor does it state a maximum period for the applications and re-evaluation of the need of price controls. In this case, the Minister of Finance enjoys discretion over the implementation of the law and might become a target of interested groups that might benefit from such controls. Furthermore, the decision on the prices to be regulated does not entail any opinion of the Competition Authority regarding market conditions that could merit temporary price controls. In other countries such as Romania, the Romanian Competition Law requires the government to seek the Competition Council’s advisory opinion before instituting price-control measures. Such a practice ensures that government intervention does not run counter to the competition policy objectives, and that the policy option selected is the ‘least restrictive’ of competition in the market.
Barriers to entrepreneurship (to market entry and rivalry) are another leading contributor to the high economy-wide PMR score. These include regulatory barriers that are likely to create strong disincentives for potential entrants by making entry more costly and forcing potential players to stay out of the market, and rules which restrict the ability or incentives to compete once they have entered. Figure 6 shows that Kenya is one of the countries in the sample where barriers to entrepreneurship are most significant, ranking lower only to Brazil, Nicaragua, Jamaica, China, Honduras, and India.

In practice, market structure in Kenya seems more concentrated than in other countries in the region. According to data from the World Bank Enterprise Survey for a number of selected manufacturing subsectors, in Kenya duopoly and oligopoly are the prevailing market structure compared to Tanzania, Uganda, and Zambia (Figure 7). Only in the paper, publishing, printing and record media, and basic metals subsectors does the market structure appear to be slightly more prone to competition relative to Tanzania, Zambia, and Uganda, while the opposite is true for all remaining subsectors (i.e. food, garments, wood, chemicals, non-metallic mineral products, basic metals, fabricated metal products, and furniture).

Section 102 of the Energy Act 2006 provides that the Minister may on the recommendation of the Commission, make regulations determining the retail prices of petroleum and petroleum products.

Price floor

Price floors are the lowest legal price at which goods or services can be sold. The reasoning behind governments imposing price floors is to prevent prices from being too low. For example, in the agriculture sector, price floors could be justified on the ground of protecting farmers from unfavorable harvesting conditions in special situations. Another sector where minimum prices are introduced is professional services. In this case, minimum price limitations are often justified by professional associations due to the intention of maintaining certain quality standards in the provision of the services that would be impaired with extremely vigorous price competition.

Price floors have drawbacks and the impact of such price regulations should be carefully evaluated. In fact, imposing minimum prices above the market-equilibrium price is likely to translate into higher prices for consumers and to generate unserved demand that could have been cleared at the market-equilibrium price. Moreover, minimum prices restrain competition as producers are unable to compete over the price dimension.

Sources: Galbraith (1952); 2011 Price Control Act
Complexity of regulatory procedures is on average higher in Kenya than in the OECD, BRICS, and LAC countries. The leading contributors to Kenya’s score are issues relating to the license and permits system. In terms of Kenya’s comparative performance, the primary problem lies in the communication and simplification of rules and procedure sub-indicator, with Kenya obtaining a score higher than the OECD, LAC, and BRICS averages. This suggests that a tailored intervention across sectors targeted at simplifying rules and procedures, as well as rationalizing licensing and permits systems could have significant impacts on easing business decisions on entry and expansion. This would in turn foster competition in the market and contribute to Kenyan consumer and social welfare. This kind of program becomes more important in the context of devolution where additional regulations are imposed by county governments.

High administrative burdens on start-ups also raise barriers to entry. Looking at the administrative burden on start-ups, there is room for improvement in the administrative burdens on corporations and administrative burdens for sole proprietor firms’ sub-indicators.\(^{29}\) Kenya’s score for administrative burdens to corporations is
higher than the OECD, BRICS, and LAC average, while its score for administrative burdens for sole proprietor firms is more favorable against the BRICS and LAC average. However, the OECD average for this indicator shows that there is still significant room for improvement. In Kenya, there are a number of legal restrictions and other kinds of limitations that are likely to render entry more costly. For example, the total cost of registering a new business is equivalent to 42.7% of income per capita and mandatory procedures to register a new business take 30 days, whereas the regional average is 27.3. A comprehensive licensing reform initiative was undertaken in Kenya several years ago, following the establishment of Working Committee on Regulatory Reform in 2005. This led to significant savings for the private sector and the emergence of Kenya among the top 10 reformers in the World Bank’s 2008 Doing Business report. This reform agenda remains ongoing and would benefit from continued attention from policy-makers.

These results are confirmed by the Doing Business ranking developed by the World Bank; in 2015, Kenya ranked 136th out of 189 economies. At the subnational level, doing business is easiest in Malaba, Narok, and Thika among the 13 Kenyan localities surveyed in Doing Business in Kenya 2012. Table 2 shows Kenya’s performance along the different topics in 2015. The main challenges seem to be the following:

- Getting electricity supply which takes 158 days on average in Kenya;
- The ease with which businesses can secure rights to property which takes an average of 72 days in Kenya compared to 57.2 days in the other Sub-Saharan Countries.

Similarly, the Global Competitiveness Report shows that, compared to the average of Sub-Saharan Africa countries, Kenya ranks lower in terms of factors that contribute to more efficient goods market, mainly due to burdensome red tape. Table 3 compares Kenya’s ranking in each of the components of goods market efficiency to the Sub-Saharan Africa (SSA) best performer. In Kenya, in order to start a business one needs to go through 10 different procedures, while in Sub-Saharan Africa an average of seven procedures needs to be undertaken, and in the best performer country that is Rwanda, the number is only 3. This evidence supports the claim that in Kenya there are excessive red tape restrictions on entry, which are likely to reduce the willingness of potential entrants, especially smaller firms, to join the market.

### Table 2: Doing Business Rankings – Kenya’s Ranking in 2015 (Out of 189 Economies)

<table>
<thead>
<tr>
<th>Topics</th>
<th>Kenya’s ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Starting a Business</td>
<td>143</td>
</tr>
<tr>
<td>Dealing with Construction Permits</td>
<td>95</td>
</tr>
<tr>
<td>Getting Electricity</td>
<td>151</td>
</tr>
<tr>
<td>Registering Property</td>
<td>136</td>
</tr>
<tr>
<td>Getting Credit</td>
<td>116</td>
</tr>
<tr>
<td>Protecting Investors</td>
<td>122</td>
</tr>
<tr>
<td>Paying Taxes</td>
<td>102</td>
</tr>
<tr>
<td>Trading Across Borders</td>
<td>153</td>
</tr>
<tr>
<td>Enforcing Contracts</td>
<td>137</td>
</tr>
<tr>
<td>Resolving Insolvency</td>
<td>134</td>
</tr>
</tbody>
</table>

### Table 3: Global Competitiveness Index – Goods Market Efficiency, 2013–2014 (Ranking Out of 148)

<table>
<thead>
<tr>
<th>Index component</th>
<th>Kenya’s ranking</th>
<th>SSA best performer</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. procedures to start a business</td>
<td>116</td>
<td>3</td>
</tr>
<tr>
<td>Prevalence of trade barriers</td>
<td>126</td>
<td>21</td>
</tr>
<tr>
<td>No. days to start a business</td>
<td>108</td>
<td>5</td>
</tr>
<tr>
<td>Business impact of rules on FDI</td>
<td>100</td>
<td>7</td>
</tr>
<tr>
<td>Total tax rate, percent profits</td>
<td>100</td>
<td>8</td>
</tr>
<tr>
<td>Burden of customs procedures</td>
<td>97</td>
<td>11</td>
</tr>
<tr>
<td>Effect of taxation on incentives to invest</td>
<td>93</td>
<td>9</td>
</tr>
</tbody>
</table>

Source: Global Competitiveness Report 2013-2014 data

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The government of Kenya has initiatives to reduce the regulatory burden through the use of Information and Communication Technology (ICT), which could have positive effects on the business environment. Kenya’s Business Licensing e-Registry was an initial effort to provide easy access to information about requirements for business licenses and permits. However, maintaining an updated database has been a challenge. The government has recently launched the e-Citizen portal that provides access to information and services provided by the government, mostly relating to services for citizens (such as marriage registration and driving licensing), but also including business name registration. In addition, operating the National Digital Registry Service and issuing e-IDs will provide access to data on individuals and their assets. This will facilitate compliance with various licensing and registration procedures prevalent at the subnational level and in sectors such as agriculture. Various county governments have also embarked on initiatives to use ICT for business registration and construction permits, which could also facilitate compliance. Nonetheless, the use of ICT is only a means to achieve greater efficiency of government services and a complement to a good regulatory framework.

Barriers to trade and investment are higher in Kenya than in the OECD countries. Kenya’s score is also higher than the BRICS and LAC averages (Figure 8). Within the sample, only Honduras and Brazil have more restrictive regulations that directly affect trade and investment.

High barriers to trade have also been pointed out as an impediment for competitiveness. The Global Competitiveness Report shows that rules and regulations in Kenya discourage foreign direct investment (FDI) more so than in other countries (see Table 3 above). This might represent a relatively weak position for Kenya in attracting foreign capital, which could support the development of the economy. According to the survey, although imports account for more than 40 percent of the GDP, customs procedures are not very efficient in Kenya. The situation does not improve when considering non-tariff barriers (e.g., health and product standards, technical and labeling requirements, etc.); the presence of strong NTBs could limit the ability of imported goods to compete in the domestic market. According to the East African Common Market Scorecards, which covers the period 2008-2013, of the 51 reported NTBs, Kenya accounted for 31
percent, second only to Tanzania.\textsuperscript{31} In the category of unresolved NTBs, Kenya ranked highest in the region with 7 out of the 21 unresolved NTBs in the same period.\textsuperscript{32}

In Kenya there is room for improvement both in terms of explicit barriers to trade and investment (i.e., barriers to FDI and tariff barriers) and other barriers to trade and investment (i.e., different treatment of foreign suppliers and barriers to trade facilitation). Figure 9 compares Kenya’s score for these sub-categories with OECD, BRICS, and LAC averages. Kenya’s scores are higher than OECD and LAC averages for the first sub-indicator, and higher than OECD, LAC, and BRICS averages for the second sub-indicator. The higher score for Kenya stems from regulations that prescribe differential treatment of foreign suppliers in professional services and public procurement, and from the lack of mutual recognition agreements in key sectors, which act as an impediment to trade. Relatively high average import tariffs for goods, particularly agriculture products, also contribute to the high score.

**Figure 9: PMR Score for Subindicators**

(Scale is 0–6, from least to most restrictive of competition)

<table>
<thead>
<tr>
<th>Score (0–6)</th>
<th>Explicit barriers to trade and investment</th>
<th>Other barriers to trade and investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.28</td>
<td>1.34</td>
<td>1.78</td>
</tr>
<tr>
<td>0.77</td>
<td>1.84</td>
<td>2.23</td>
</tr>
<tr>
<td>2.35</td>
<td>2.35</td>
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</table>


In addition to removing explicit barriers to trade, increasing cooperation at the regional level in the regulatory dimension would also be beneficial for Kenya. Regulatory cooperation with neighboring partners who have similar regulatory objectives could assist in incentivizing or accelerating the development of certain standards or the reform of licensing and permits systems. This is especially true in cases where mutual recognition agreements are already in place. It may therefore be worthwhile for policymakers to attach due importance and prioritization to regional regulatory initiatives, given the supporting role they can play in facilitating national reforms.

Investment incentives are another tool that governments use to attract investors and facilitate private sector participation and they have an effect on market competition. Investment incentives encompass tax exemptions, loan guarantees, grants, government resources (such as land, spectrum, or water) provided at prices below market level, subsidies, cash transfers, accelerated depreciation allowances, and capital injections, among others. In designing these schemes, special attention should be given to their effect on the dynamics of market competition. Investment incentives granted to select firms can negatively affect competition through two channels. First, they can facilitate anticompetitive behavior, in that they can create or protect dominant players in markets, unduly incentivize firm consolidation (which increases the risk of cartel formation), and create barriers to entry that prevent future competition. Second, they can generate market inefficiencies, in that incentives can discourage beneficiaries from enhancing productive efficiency and innovating.
Incentives are policy instruments that governments can use to encourage particular activities so as to foster economic or social development in certain areas.

The implementation of incentive schemes might be conducive to anticompetitive effects when not properly designed. Economic theory suggests that the benefits that the incentive brings about should outweigh the costs, in terms of negative effects on trade and competition in the markets. In assessing the effects of investment incentives one should not only consider the welfare of the recipients, but also the potential impact on competitors, consumers, and other stakeholders such as input suppliers (e.g. labor).

As a rule of thumb, incentives should have the following features to be effective and to minimize distortion of competition:

**Fit for purpose:** Incentives should be such that they are apt to achieve the purpose they have been designed for.

**Non-discriminatory:** Incentives should not favor one specific company in the market or one specific technology/production as this would distort competition.

**Non-selective:** All players within a particular market (for which the incentive is designed for) should be able to benefit from the incentive.

**Time-bound:** Incentives should respect time-bound limits to allow for reassessing their rationale.

Some exceptions might apply; for instance, there might be social reasons driving the implementation of discriminatory incentives that support the development of green energy plants rather than traditional plants, but this intention has to be explicitly considered as the policy objective.

In Kenya, the Investment Promotion Act, 2004 (IPA) established a corporate body known as the Kenya Investment Authority (KenInvest) with the purpose “to promote and facilitate investment by assisting investors in obtaining the licenses necessary to invest and by providing other assistance and incentives”. Under the IPA, investment is defined as “the contribution of local or foreign capital by an investor, including the creation or acquisition of business assets by or for a business enterprise and includes the expansion, restructuring, improvement or rehabilitation of a business enterprise.” KenInvest was designed to be a ‘one stop shop’ for investors.

However, the Kenyan framework encompasses different incentives covering various sectors of the economy. The main incentives available in Kenya consist of tax exemption or regulatory exemption. For instance, the Investment Deduction Allowance permits tax-free capital investments; Export Processing Zones (EPZs) benefit from a 10-year tax holiday and VAT exemption. For EPZs there is no minimum level of investment and any proportion of foreign or local shareholding is permitted.

A recent report on tax incentives by the Kenyan Institute of Economic Affairs showed that in Kenya low rates of taxation may promote investment; however, there is minimal evidence that discriminatory tax incentives are better placed to promote investment than simple, uniform regimes with low to moderate rates of taxation. According to section 13 of the Income Tax Act, the Minister may, by notice in the Gazette,
provide income tax exemptions. However, the basic criteria for such exemptions are not specified in the legal framework. In the past, exemptions have been granted on a case-by-case basis with potential negative effects on competition in some markets. Section 23 of the old VAT Act provided for discretionary powers that would allow taxpayers to be granted VAT waivers by the government. Nonetheless, it is important to note that this section or a mirror of the same was removed and the current VAT Act 2013, addresses, to some extent, discretion in granting tax remissions, another potential source of distortions.

Moreover, according to the IPA, investors may be granted an Investment Certificate, which entails such benefits as entitlement to all licenses required for his or her operations, and work permits for three members of management or technical staff and three shareholders or partners valid for two years each. Obtaining the Investment Certificate at KenInvest’s “one-stop” is beneficial because Kenya has rather extensive licensing requirements. It is important to note that the IPA sets the criteria for granting a certificate, but one of the criteria (an investment being beneficial to Kenya) could be subject to discretion.

Sources: The Investment Promotion Act (2004); KenInvest website; UNCTAD (2012); IEA (2012)

and can drive out more or equally efficient firms that do not benefit from the incentive scheme. Therefore, investment incentives need to minimize negative effects on competition while targeting the specific policy goal. Box 5 explores the topic of investment incentives in greater detail.

An additional concern in Kenya is that some rules discourage foreign ownership in certain sectors. Restrictions on foreign ownership have been justified in the past on national security grounds; nevertheless, in a globalized world, this kind of regulation is likely to restrain investment and competition, de facto altering entry conditions. Part II of the report will point out sectors where foreign ownership restrictions are present and may affect sector performance.

In sum, the high economy-wide PMR score for Kenya suggests that in various sectors of the economy, regulations are likely to restrain competition. Recalling the findings this section of the report, ill-designed regulations can impair economic growth and development. The next section will focus on pinpointing the regulations and rules that create obstacles to competition and that characterize the most relevant sectors in the Kenyan economy.33

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33 Sector selection relied on a number of different criteria including: (i) computation of sector-specific PMR scores to determine the degree of restriction to competition, and (ii) sectors’ relevance to the Kenyan economy (in terms of added value, number of workers and relevance for consumers).
This part of the report highlights regulatory obstacles to competition that constrain the performance of key sectors of the economy. The sectors chosen for analysis were selected based on their importance to the economy relative to other candidate sectors, their alignment with the objectives of Kenya’s Vision 2030, and a preliminary analysis of the restrictiveness of the regulatory framework on competition in candidate sectors. Their relevance to the economy was assessed based on their contribution to GDP, consumer expenditure, employment, and the costs of operating a business (Figure 10, annex 3). In the case of telecoms, electricity, air transport and professional services, as well as being of high relevance to the Kenyan economy given that the output from these industries constitutes a major input in the production of firms in downstream sectors, an additional rational for selecting these sectors is that they are currently covered by the OECD PMR methodology in a number of other countries, which allows for Kenya’s performance to be benchmarked against best practice and peer countries. Thus, the sector-specific PMR indicators were used to assess network services and professional services (see annex 4 for more details on the components of the indicators). In addition, the World Bank Group framework for identifying regulations that restrict competition was applied to sectors not covered by the PMR methodology.

2.1 AGRICULTURE

In Kenya, agriculture is crucial not only for the economy, being one of the main economic drivers, but it is also a fundamental pillar of social policy as it is a key contributor to the country’s livelihood and food security. Agriculture represents about 25 percent of Kenya’s Gross Domestic Product (GDP) and provides about 75 percent of industrial raw materials, indirectly affecting manufacturing, distribution, and other service-related sectors (GoK, 2010). Food production plays an important role in maintaining the country’s food security. Moreover, a large fraction of agriculture is devoted to export-oriented production, which is a main driver of the country’s economic performance. The sector accounts for 65 percent of Kenya’s total exports, and it employs two-thirds of the working population, of which only 18 percent accounts for formal employment (KNBS, 2014). Given the relevance of the agriculture sector for the Kenyan economy, this sector will be treated with caution throughout the following subsections and only reasonable recommendations will be advanced.

Figure 10: Relevance of the Analyzed Sectors in terms of GDP, Consumer Expenditure, Employment, and Business Operating Costs


Note: (1) Operating costs also include labor costs and research and development.
Kenya’s Vision 2030 envisages agriculture as a key sector through which annual economic growth rates of 10 percent can be achieved. Under the National Agribusiness Strategy, Kenya aims to promote an “innovative, commercially-oriented, and modern agricultural sector”. This is expected to be accomplished through the following: transforming key institutions in agriculture and livestock to promote agricultural growth; increasing productivity of crops and livestock; introducing land use policies for better utilization of high and medium potential lands; developing more irrigable areas in arid and semi-arid lands for both crops and livestock; and improving market access for smallholders through better supply chain management. In particular, the Vision 2030 flagship actions for 2012 included the following:

(i) Implementation of consolidated agricultural policy reform legislation. This initiative sought to review and harmonize the legal framework to rationalize contradictory development, regulatory, licensing, processing, and roles of agricultural parastatals;

(ii) Development and implementation of a three-tiered fertilizer cost reduction program. The Government has been procuring (in bulk) and distributing fertilizer at a subsidized rate to farmers across the country in order to stabilize fertilizer prices;

(iii) Improvement of the value gained in the production and supply chain through branding Kenyan farm products;

(iv) Creation of the Disease-Free Zones and livestock processing facilities to enable Kenyan meat, hides and skins to meet international marketing standards.

However, the agriculture sector presents some critical challenges in terms of productivity and marketing constraints. Much of the Kenyan agriculture sector is characterized by low productivity and little value addition and this makes Kenyan products uncompetitive in the international markets. Productivity levels for many crops are below potential, and the yield and value of some agricultural produce over a 5-year period have either remained constant or are on the decline. Similarly, the production level for most fish and livestock products is below potential (GoK, 2010). This is mainly due to high production costs linked to poor access to input markets, high energy prices, poor infrastructure, and low utilization of land for agriculture. The productivity of the agricultural sector is constrained by inefficiencies in the supply chain resulting from limited storage capacity, lack of post-harvest services, and poor extension services. In agriculture, value addition determines the competitiveness of the country’s produce in world markets. However, Kenyan farmers export semi-processed, low-value produce, which accounts for 91 percent of total agriculture-related exports (GoK, 2010). The limited ability to add value to agricultural produce, coupled with high production costs, make exports less competitive.

The agriculture sector is also closely linked to the country food security policy, so the government is often involved in the sector. Government interventions are typical in the agriculture sector, where they aim to address “market failures”. The main types of market failures in the agribusiness sector are externalities, imperfect or asymmetric information, market power, and public goods. An externality occurs when the production or consumption activity of one subject has spillover costs or benefits for another, who did not choose to incur that cost or benefit. Examples of externalities in the agriculture sector include a system that depletes organic matter or erodes soil (negative externality), and one that protects on-farm beneficial wildlife for pest control (positive externality). Information asymmetry occurs when

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34 When markets “fail”, the signals and the incentives they provide to economic agents no longer guarantee that scarce resources are allocated efficiently.
sellers and buyers have access to different sets of information on product characteristics. This type of asymmetry mostly affects the final stage of the agriculture value chain in which consumers have a limited ability in assessing the quality and safety of food products. Market power is normally defined as the ability of an individual firm to influence and charge prices above competitive levels. In the agriculture sector, there is a pronounced risk of strong concentration in the upstream markets for chemicals where, due to strong economies of scale or limited access to essential inputs, large firms may be in the position to exert significant market power. Public goods are those goods that are non-rival and non-excludable. In the agriculture sector, irrigation infrastructure is an example of a public good. The government has a key role in overcoming all of these market failures, choosing policy instruments that are proportional to the benefits they pursue, and minimizing distortions on markets, especially in agriculture-based countries.

In Kenya, the government is often involved in the agriculture sector; for example, during food crises. According to the Kenya Agricultural Research Institute, in past years the GoK responded to the food crises through three major policy interventions: direct purchase and provision of subsidized inputs; price control policies; and establishment of funds for producers. Supply related policies include subsidies on farm inputs, especially fertilizers, through the involvement of the National Cereals and Produce Board (NCPB) in the import and distribution of the inputs, and allowing for imports of tax-free maize and bans on maize exports. In terms of price related policies, the NCPB purchases maize from farmers at prices higher than market prices to provide incentives to producers. In addition, the government provides subsidies to maize meal millers to bring down the consumer retail prices of the maize meal (price subsidy to the consumers), and manages a fund to purchase livestock from the drought stricken areas.\footnote{Food Security Report, available at \url{http://www.foodsecurityportal.org/kenya/food-security-report-prepared-kenya-agricultural-research-institute}}

This section will delineate the possible regulatory limitations in the main subsectors and provide recommendations on how to successfully reduce those obstacles to competition and well-functioning markets. It should be noted that this analysis is based on a review of national legislation and does not extend to county legislation. Nevertheless, there are a number of regulations at the county level which could affect competition within and between counties, such as the imposition of county taxes on agricultural produce (such as cess). These merit a more detailed review as part of a future analysis.

**New Legal Framework**

In recent years, the agriculture sector has been subject to a radical change in terms of legal framework. A new set of sector-specific rules are being implemented in line with the provisions of the 2010 Constitution that required devolution of mandates to counties. The new acts have not been operationalized yet; hence, drawing clear-cut conclusions on how they will affect competition is challenging. In many cases implementing rules will determine their effects. The agriculture package consists of the following pieces of legislation: The Agriculture, Fisheries and Food Authority (AFFA) Act 2013, The Kenya Agricultural and Livestock Research Act 2013, and the Crops Act 2013.

**Agriculture, Fisheries and Food Authority Act\footnote{Available at \url{http://www.parliament.go.ke/plone/statutory-documents/agriculture-fisheries-and-food-authority-act-no-13-of-2013/view}}**

This act merges the various parastatals associated with agriculture into a single entity: the Agriculture, Fisheries, and Food Authority (AFFA). This consolidation is aimed at removing overlapping regulatory, licensing, processing, and marketing functions. Stakeholders, however,
fear that such a measure will allocate resources back in the public sector, after some subsectors, now falling under AFFA, have been successfully moving towards greater private participation.\textsuperscript{37} The new legislation also follows the new Kenyan constitution guidelines for distribution of power (empowering the 47 counties) and transparency in the distribution of government funds. In addition, the Act mandates the separation of regulatory and commercial activities. Institutions carrying out commercial activities will be transformed into companies. This is a positive step towards facilitating competitive neutrality. However, there are some provisions that need to be further developed in the regulations in order to prevent market distortions. For instance, the law prohibits exports of some raw products (cashew nuts, pyrethrum, bixa, and macadamia) but exceptions can be provided by the Cabinet Secretary with approval of the National Assembly. It also mandates AFFA to ensure that there are no dominant undertakings in the sector without restricting government enforcement to situations of abuse of dominance as mandated by the Competition Act. In addition, the Cabinet Secretary has broad powers to provide exemptions or conditional exemptions to any land use regulations.

\textit{Kenya Agricultural and Livestock Research Act}\textsuperscript{38}

This Act provides an administrative framework for agricultural research in Kenya and provides for the promotion and coordination of research activities on seeds, propagation material, artificial insemination, and specific crops in Kenya.

\textit{Crops Act}\textsuperscript{39}

This Act seeks to accelerate the growth and development of agriculture, enhance productivity and incomes of farmers and the rural population, improve the investment climate and efficiency of agribusiness, and develop agricultural crops as export crops. Its purpose is to promote the production, processing, marketing, and distribution of crops in suitable areas. However, the law creates licensing, farmer registration and compulsory certification requirements for various crops, increasing the regulatory burden and potentially restricting competition. Regarding licensing, the license lasts only for one year and the licensing authority can at any time vary the conditions of the license or impose further conditions on the license, creating uncertainty for investors. The Act provides specific registration requirements to farmers for certain crops, potentially increasing switching costs for farmers among processors. Compulsory certification for certain crops (including tea, coffee, Irish potatoes, sunflower, soya beans, maize, rice, sorghum, and wheat) could drive smaller players out of the market. Finally, the Act also indicates the need to develop regulations to set formulas for pricing of scheduled crops that could potentially reduce the incentives to compete in those crop markets.

\textit{Staple Grains: Looking for Market-Based Alternatives to Ensure Price Stability and Product Availability}

Over the past years, the cereal market in Kenya has experienced a productivity slump, contrary to the trend in other Sub-Saharan countries and world developments. Cereal yield in Kenya has decreased in the past few years, with a deep plunge in 2011 when only 1,515 kilograms per hectare of harvested land was produced.\textsuperscript{40} Productivity slightly recovered in 2012 with 1,659 kilograms per hectare.\textsuperscript{41} In addition, agricultural productivity, measured as value added per

\textsuperscript{37} Based on Mr. Mudibo’s (Chairman of Agricultural Industry Network) release, available at http://mobile.nation.co.ke/business/Players-want-talks-on-sector-laws/-/1950106/2004762/-/format/xhtml/-/6kf44m/-/index.html

\textsuperscript{38} Available at http://www.parliament.go.ke/plone/statutory-documents/kenya-agricultural-and-livestock-research-act-no-17-of-2013

\textsuperscript{39} Available at http://www.parliament.go.ke/plone/statutory-documents/crops-act-no-16-of-2013

\textsuperscript{40} Cereal yield, measured as kilograms per hectare of harvested land, includes wheat, rice, maize, barley, oats, rye, millet, sorghum, buckwheat, and mixed grains.

worker (Figure 11), has improved very little over the past decades. Comparing productivity in 2000 and 2012, Kenya only reports a US$17 (at 2005 value) increase in the value added per worker. The Sub-Saharan countries on average recorded a dramatic improvement in productivity (from US$491 of value added per worker in 2000, to US$765 in 2012), in line with the world trend.\(^\text{42}\)

In addition, in the past two decades, there has been a growing production deficit, both in terms of maize production and wheat production. Figure 12 plots the production and consumption of maize in the years between 1996 and 2010. It stands clear that there has been a production deficit in most of the crop seasons, with an average deficit of around 300,000 metric tons (MT), which is usually filled by informal cross-border trade from Uganda and Tanzania. The present production deficit (estimated at 400,000 to 700,000 MT) has been supplied by imports from the international market (ACDI VOCA, 2010).

Such market inefficiencies may be explained by regulatory obstacles that constrain the development of the sector in Kenya. To understand the current set-up, it is necessary to present a historical overview.

The grain subsector is a complex field of the economy because sensitive policy-making is highly critical given the involvement of many interests. For instance, governments may want to ensure adequate food supplies, protect and preserve small-scale farms, reduce price instability, and minimize dependence on imports. Moreover, the agriculture sector is usually characterized by the presence of organizations that are (or used to be) directly controlled by the government with the mandate of stabilizing prices. Indeed, price instability is a major issue affecting all agricultural commodities, and represents a source of risk for most Kenyan farmers and households.

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Instability in agricultural prices may arise from different factors, ranging from climatic factors to information asymmetry, to volatility in the international market. Such market failures might be addressed either through market or non-market policies. The broad objective of such policies would be to improve the welfare of the commodity producers by reducing volatility, raising average prices, and incomes. However, economic theory shows that the main cause of price instability is in fact trade restrictions (Stiglitz and Newbery, 1979). Moreover, the objective of eliminating trade restrictions often conflicts with the objectives of improving consumer welfare and of alleviating poverty in countries where agricultural products account for a significant proportion of household expenditure for a large part of the population.

The traditional policy response to price instability in Kenya has consisted of direct government intervention in food markets. The Kenyan Government is directly involved in the food market through the marketing board, the National Cereal and Produce Board (NCPB). The government has enforced strict price controls on maize purchases from farmers, with uniform prices across regions and seasons, and restrictions on both internal and external trade. Maize is one of the main staple crops in Kenya and the most consumed cereal for a large proportion of the population in both urban and rural areas. Annual consumption is around 80kg per capita and accounts for approximately 35 percent of gross caloric intake. Per capita consumption has slightly declined over the past decade, reflecting the gradual rise of alternative staples in Kenyan diets, but there is still no other staple with a consumption share that approaches that of maize (The World Bank Group, 2014).

Currently, the GoK intervenes in the maize sector through two main policy instruments: (i) contracting the NCPB for some strategic operations and; (ii) controlling imports through import tariffs. Stakeholders reported that the role played by the NCPB is likely to distort competition in the market, given that the NCPB purchases up to 35 percent of the marketable surplus of maize. Box 5 summarizes the main limitations to competition posed by the presence of the NCPB at all levels of the value chain.

Government intervention inevitably leads to gains for some and losses for others. Empirical research shows that the activities of the NCPB benefit farmers by increasing the market price for maize (Mather and Jayne, 2011). However, Jayne et al. (2008) found the maize marketing policy pursued by the government, through the NCPB, led to a reallocation of income from urban consumers and a majority of small-scale households (net buyers of maize), to a relatively small number of large and small-scale farmers (sellers of maize).

The government seems to protect local production through import duties, which impede price transmission from world markets to Kenya. Currently, maize is imported at a 50 percent duty rate, while the wheat tariff is at 10 percent. Such rates were initially meant to be gradually reduced to align them to the free trade area rules of COMESA. However, import policy has not followed a consistent pattern throughout the years. In the past 10 years, there have been periods of duty remissions (e.g., during the wave of liberalization in 1993), followed by periods of import bans (e.g., the 1996 import ban following a poor harvesting season). The ban on imports of genetically modified maize, and the way in which it has varied over time, has also affected the market. Indeed, it emerged from various sources that so far, the Kenya food policy approach has been reactive rather than proactive; such a policy might become very costly for the government and create uncertainty among stakeholders.

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44 Lear stakeholders’ interviews, and Short et al. (2012).
BOX 5: THE ROLE OF THE NCPB

The NCPB was established by the Government of Kenya in 1979 by merging the Maize and Produce Board with the Wheat Board of Kenya in order to stabilize grain markets through the control of prices, the purchase of domestic maize production and the management of a public buffer stock, called the Strategic Grain Reserve (SGR). After liberalization in 1993, NCPB reduced its maize purchases and left greater scope to private operators. However, since 2000, the government has gradually increased NCPB’s purchases again in an attempt to protect farmers from aggressive competition coming from the COMESA region and temporarily address drought and food crises.

The NCPB’s core business consists of commercial grain trading. In this respect, the NCPB deals with various products (e.g. rice, beans, and agricultural inputs) and offers related services to its clients (such as weighing, drying, grading, and leasing equipment), in competition with other players in the industry. Besides its commercial role, the NCPB also carries out social functions such as procuring, storing, and maintaining an SGR stock of up to 8 million bags (more than 700,000 tons) on behalf of the government to be used for price stabilization purposes. The NCPB also manages the National Famine Relief Program on behalf of the GoK.

Considering the price stabilization mechanism, since liberalization, the government contracts the NCPB to purchase a given quantity of bags of maize to form the SGR. According to the NCPB, the price of purchase is based on market analysis. Indeed, the NCPB continuously monitors the market through a network of approximately 80 officials scattered around the country. The NCPB claims that, since their purchases need to comply with very high quality standards as per the Kenya Bureau of Standards grades, purchasing imported grain is very unlikely. In addition, the purchase of maize is not carried out under competitive conditions. The NCPB directly purchases maize from farmers (mainly on a large scale) but lacks a clear, systematic tendering procedure according to stakeholders.

Influence on prices

The NCPB currently purchases a significant percentage of locally produced maize grain at a fixed price, frequently higher than the competitive market price. Purchased grain is mostly sold on to millers, with some excess sold outside of the country. From 1995 – 2004, NCPB actions are estimated to have contributed to an increase in the price of maize grain by approximately 20 percent on average during the period (Jayne et al., 2008). Regarding the maize market, the NCPB remains an important player, purchasing in normal years around 25-35 percent of the total domestically marketed maize, most of all from large-scale farmers.

Since liberalization, the NCPB has been considered by policy-makers as a buyer of last resort, although it is often unable to timely meet financial commitments towards farmers. The role of the NCPB has often been in the headlines as well as been discussed during parliamentary assemblies.

The current policy framework is likely to alter the competitive conditions in the market. First of all, farmers’ production decisions during growing seasons will be influenced by expectations of NCPB’s post-harvest activities. Moreover, while the NCPB operations have a direct impact on the upstream market only, its activities will indirectly affect prices and expectations in the downstream market.

Reform of the NCPB: focus on competing with the private sector on a commercial basis

In July 2013, a Presidential Taskforce on Parastatal Reform was established to conduct a policy review of the parastatal framework in Kenya. The aim was to design the most appropriate institutional arrangements for the country’s parastatals, taking into account governance needs as well as the viability and duplication of mandates, amongst other objectives.

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45 In Jayne et al. (2008) they use a reduced-form Vector Auto regression Model (VAR) with data, imposing only minimal identification restrictions. They show that NCPB activities have stabilized maize market prices in Kenya, reduced price levels in the early 1990s, and raised average price levels by roughly 20% between 1995 and 2004.

such policies to isolate domestic markets from international trends, coupled with price control schemes, are likely to have a greater impact in food deficit countries, such as Kenya, compared to self-sufficient countries. Moreover, most empirical analyses suggest that higher prices adversely affect poor households (rather than benefiting them through increased agricultural incomes), since the poor are often net consumers, including of imported goods (see Christiaensen and Demery (2007), Wodon et al. (2008) and Wodon and Zaman (2008)). Policies that tend to keep prices high will generate a greater negative impact in markets for staple food, where demand is likely to be inelastic. Lowering import barriers and eliminating the price control regime would increase competition in the market, and consumers would benefit from lower food prices.

removal of government interventions that increase maize prices by 20 percent would have approximately the same effect as a real income increase of 1.2 percent on average, with much greater gains falling on the poor. A decrease in the price of maize leads to increased demand, as well as a decrease in production. A recent study, taking account of these factors, estimated welfare gains in Kenya from a 20 percent fall in the price of maize. The study found that below a certain level of expenditure, households experience average welfare gains of more than 2 percent equivalent expenditure, compared to the wealthier end of the distribution, where welfare gains are below 0.5 percent. Moreover, the study estimates that the 20 percent price decrease of maize would result in a net decline in poverty of 1.8 percent. It therefore stands clear that a decline in maize prices will substantially benefit the poor (Argent and Begazo, 2014).
2. Sector-Specific Analysis of Product Market Regulations

RECOMMENDATIONS

As described in this section, price instability is one of the main issues driving government involvement in the staple food sector. However, there might be less restrictive, market-based policy options to ensure price stability. Therefore, it is recommended to scale-back price control regimes and policies that shield players from market forces, and at the same time develop the market-based alternatives. The following are expected to fully address market failures affecting the staple food sector:

- **Developing commodity exchange platforms would represent a market alternative to manage price instability and risks.** Currently in Kenya, grains are only traded in the Kenya Agricultural Commodity Exchange, which is a private sector firm facing many challenges such as: (i) lack of awareness from potential participants; (ii) individual shareholders not producing enough volume to benefit from the exchange’s services; (iii) failure to attract large-volume buyers given that commodities offered are not graded or standardized; (iv) the exchange not providing complementary services (i.e., storage and, reliable commodity market information, such as domestic, regional, and market prices); and (v) potential buyers lacking credit to finance purchases (Mbeng Mezui et al., 2013).

- **Developing better futures market can reduce farmers’ risk-bearing.** Indeed, thanks to future contracts, both farmers and buyers can hedge their positions; for example, a farmer selling maize can today sell his future production, which will only be harvested at a future point in time, and guarantee the price he will be paid when he delivers. At the same time, buyers can purchase in the futures market and hedge their position against an increase in price at delivery date. In South Africa, for instance, the use of the South African Futures Exchange (SAFEX) has facilitated a reduction in the price of maize.

- **Exploiting and promoting the Warehouse Receipt System (WRS).** The WRS facilitates farmers’ access to credit. Receipts are given to farmers for their products held on storage and can be used as collateral, sold, traded, or used for delivery against financial instruments, including futures contracts. Box 7 explores the current situation and the viability of developing such system further in Kenya.

- **Maintaining impetus in the reform of NCPB to separate its commercial functions from its social functions, including the maintenance of the SGR.** Moreover, a full assessment of the impact of this reform on the private sector’s ability to serve the market could be carried out to ensure that NCPB reform efforts are structured in a way which guarantees competitive neutrality between the private sector and the new commercial entity. In addition, it would be beneficial to ensure that moves to create a commodity exchange and for GCK to operate a warehousing unit are complementary to current efforts to develop these mechanisms and encourage private participation in their implementation.

- **Adopting other complementary policies such as improving farmers’ access to credit and promoting diversification.** Establishing better credit markets would enable farmers to spread their income fluctuations over a number of years. Better borrowing capacity would alleviate the effects of price instability without the need for significant government intervention. Supporting diversification programs—promoting farmers’ crop

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47 Commodity exchanges are organized marketplace where buyers and sellers come together to trade commodity-related contracts following rules set by the exchange. Exchanges might be organized in different ways, but they tend to have the following elements in common: (i) an exchange provides a trading platform (e.g. physical location or electronic trading system); (ii) it provides standard contracts; (iii) in an exchange, users will not interact directly, but through brokers; (iv) it provides security on the quality and quantity of the commodities traded; (v) it guarantees logistics; (vi) it is strictly regulated (Mbeng Mezui et al., 2013).
Unlocking Growth Potential in Kenya

Diversification, both horizontally (adding more crops to the current system) and vertically (taking on downstream activities), is likely to help farmers spread the risk associated with each crop over a wider crop and activity portfolio.

Industrial Crops – Pyrethrum and Tea: Facilitating Private Investment and Easing Entry Restrictions

The case of pyrethrum

Pyrethrum, a natural insecticide, has been one of the main foreign exchange earners of Kenya until a few decades ago. Pyrethrum was first introduced in Kenya in 1928, and by 1940, Kenya had replaced Japan as the dominant world supplier of pyrethrum extract. The country presents a natural comparative advantage for the production of pyrethrum due to the ideal climatic and geographic conditions. In the 1980s, pyrethrum was one of Kenya’s largest cash crops accounting for more than 25 percent of total agricultural exports in 1980. The industry was once the main source of income for 200,000 farmers and supported an estimate done million people. Most of the pyrethrum produced has been for the export market, mainly the USA, Europe, Japan, Asia and Africa, with the local market consuming less than 2 percent.

Having been the leading exporter, Kenya lost its position in the world market, gradually reducing production and currently accounting for as little as 2 percent of the global supply, while other countries such as Australia (approximately 70 percent market share in 2013) took over. Production peaked in the early 1980s, when Kenya accounted for more than 80 percent of the global supply, and dramatically declined by the end of 1980s (Figure 13, blue line), never recovering to the previous production rates. Looking at the area harvested (Figure 13, grey bars) it is possible to see that since the early 1980s the arable land devoted to pyrethrum crop has declined significantly, suggesting that farmers have switched to other areas of production.

2. Sector-Specific Analysis of Product Market Regulations

BOX 6: THE WAREHOUSE RECEIPT SYSTEM

Warehouse Receipt Systems (WRSs) are an important and effective tool for creating liquidity and easing access to credit. Such schemes also offer additional benefits such as smoothing the supply and prices in the market, improving growers’ incomes, and reducing food losses.

The WRS, also known as inventory credits, can facilitate credit for inventory or products held in storage. These receipts, sometimes known as warrants, when backed by legal provisions that guarantee quality, provide a secure system whereby stored agricultural commodities can serve as collateral, be sold, traded, or used for delivery against financial instruments including futures contracts. These receipts are documents that state the ownership of a specific quantity of products with specific characteristics and stored in a specific warehouse.

Currently in Kenya, there are two certified WRSs: the Eastern Africa Grain Council (EAGC); and the National Cereal and Produce Board. At the moment there is no legal framework guiding the certification process. Moreover, the Kenya National Federation of Agricultural Producers (KENFAP) study revealed that there is little awareness of this system among farmers and current requirements, in terms of quality standards and minimum quantity, make it mainly accessible to large-scale producers and, to a lesser extent, small farm holders.

Sources: Giovannucci et al. (2000); KENFAP (2011)
2. Sector-Specific Analysis of Product Market Regulations

Figure 13: Pyrethrum Area Harvested and Production in Kenya, 1961-2011

Source: FAOSTAT data

One explanation for the decline in production has been the regulatory set-up and the existence of a single processor. The 1964 Pyrethrum Act provided for the establishment of the Pyrethrum Board of Kenya (PBK) as a body corporate and defined its functions, powers and internal organization. According to the 1964 Act, the PBK functions were to grant licenses to pyrethrum growers, determine the annual quota of pyrethrum flowers which may be produced in Kenya, and be responsible for the processing and marketing of pyrethrum as well as the sorting, grading, or examination of any pyrethrum or pyrethrum product. The PBK has been the sole processor of pyrethrum in Kenya and managed the only two pyrethrum-processing factories that are authorized to process pyrethrum. The PBK used to provide inputs to the farmers who in turn sold their produce to the PBK, which processed and marketed the refined extract in Kenya and abroad (Export Processing Zones Authority, 2005).

The previous regulatory framework disallowed private investments in the production of planting material, processing, and refining of pyrethrum products in Kenya. Under the previous act, entry in these markets was prevented as the PBK was the only entity entitled to purchase and take deliveries of pyrethrum extracts in Kenya and for exports.

The new act partially liberalizes the market; however, some regulatory constraints remain. In 2013, the 1964 Act was repealed by a new Pyrethrum Act (2013 Act) and the Crops Act 2013. Under the new regulatory framework, the Agriculture, Food and Fishery Authority (AFFA) will register processors, formulators, and persons running pyrethrum nurseries; coordinate the activities of stakeholders and organizations within the pyrethrum industry; set required standards for pyrethrum products; facilitate equitable access of benefits and resources of pyrethrum industry by all interested parties; facilitate the arbitration of disputes among interested parties; and promote and encourage the use of environmentally friendly technologies in the pyrethrum industry. On paper, the processing phase is fully liberalized as the commercial arm of the former PBK (Pyrethrum Processing Company of Kenya, PPCK) will compete along with other pyrethrum processors. However, since the implementing regulations are not yet in place, to date, no other processor has been licensed. Issues regarding registration requirements to sell pyrethrum in foreign markets

48 Available at http://www.kenyalaw.org:8181/exists/kenyalex/actview.xql?actid=CAP%20340
49 Available at http://www.kenyalaw.org:8181/exists/kenyalex/actview.xql?actid=NO.%2022%20OF%202013
50 However, as of November 2014, AFFA has received seven applications for processing licenses, as confirmed during the stakeholder meeting held with AFFA. As of April 2015, AFFA has signed a memorandum of understanding with one of the applicants that complied with the registration criteria.
such as the USA and EU constrain the possibility of entry into the market as well.

It is important that regulations currently being developed for the industry do not unduly restrict the ability to growers and processors to choose the parties with whom they transact. The Crops Act 2013, gives farmers the freedom of registering with processors. Obliging growers to register with a factory, and constraining growers to only deliver flowers to the factory with which they are registered will impair competition. This kind of restriction will affect the ability of farmers to realize the best price for their product, especially if the procedure to switch the factory with which they are registered is not sufficiently flexible. Furthermore, this rule will reainment the ability of factories, particularly new entrants, to source inputs, even where they are more efficient and could therefore offer higher prices for pyrethrum flowers.

**RECOMMENDATIONS FOR INDUSTRIAL CROPS**

- **Develop implementing regulations** that describe clear requirements and transparent procedures for granting licenses and authorizations for the participation in the pyrethrum value chain.

- **Allow the private sector to enter into contract farming agreements with growers**, give their own planting material to farmers, decide the level of purchases and prices without restraints, or freely sell or export pyrethrum products.

- **Prevent farmer registration requirements** that might lock them in with a sole processor.

- **Strengthen AFFA’s regulatory role**. The AFFA should act as a sector regulator and maintain separation from processing and marketing activities to ensure competitive neutrality. It should ensure private participation at all levels of the value chain and a level playing field with respect to the former PBK (PPCK). AFFA can also help safeguard the efficiency of the industry by ensuring that prices in the sector are determined by market forces and are not artificially subsidized. It could also facilitate access to international markets that require registration of pyrethrum products.

**The case of tea**

Kenya is one of the four main producers of tea, controlling 24 percent of the world tea export in 2012.\(^{51}\) Tea is Kenya’s major export earner, bringing in about 19 percent of total foreign exchange earnings in 2014. In the same year, the tea industry brought in KSH 101 billion in export earnings and KSH 19 billion in domestic sales, contributing 2% of Kenya’s total GDP.\(^{52}\) The tea industry structure in Kenya is characterized by a dual production system: the plantation sector, producing on a large scale for exports, and the smallholder tea subsector. The plantation sector, owned by large-scale tea producers and outgrowers, controls about 40 percent of the industry production and supports about 100,000 tea farm workers. According to industry statistics, the smallholder tea subsector currently consisted of around 600,000 registered small holder growers in 66 tea factories in 2014, and produces about 60 percent of total industry production. It is estimated that the industry directly supports over 5 million Kenyan families directly and indirectly, making it one of the leading sources of livelihood in the country.\(^{53}\)

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\(^{51}\) Data source: International Tea Committee Annual Bulletin of Statistics.

\(^{52}\) Data source: Kenya Economic Survey 2015; cited in AFFA communication with CAK, 25\(^{th}\) August 2015.

\(^{53}\) Data source: Cited in AFFA communication with CAK, 25\(^{th}\) August 2015.
Contrary to most of the other agriculture subsectors, the tea industry in Kenya is dominated by private enterprises with little government intervention, especially at the smallholder level. This is also reflected in the fact that there is currently no national tea policy (although such a policy is now under development).\textsuperscript{54}

In recent years there have been efforts to advocate for an easing of entry restrictions and an increase competition in the sector. The AFFA Tea Directorate (formerly the Tea Board of Kenya (TBK)), is mandated with the regulation of the sector and the issuance of licenses to investors. In October 2012, a private investor lodged a complaint with the Competition Authority of Kenya alleging that tea factories affiliated to the Kenya Tea Development Agency (KTDA) had opposed its request to be granted a license by the TBK to construct a Specialty Tea Factory for purple leaf tea, resulting in the TBK objecting to granting the license. The investor alleged that the incumbents had raised unreasonable objections to the granting of its application to construct a Specialty Tea Factory and that the regulator did not have valid grounds to decline grant of the license. In response, CAK provided an advisory opinion indicating that the tea market was contestable and it was therefore possible for the TBK to license more investors. As a result, the investor was granted a license and subsequently established a tea factory, investing around KSH 62 million (USD 0.6 million) in the industry and allowing the development of a new export crop for Kenya.

Despite such progress, a number of potential regulatory restrictions to entry remain. For example, according to government-issued Tea Regulations of 2008\textsuperscript{55}, prospective licensees for green leaf tea must provide proof of having established a minimum of 250 hectares of mature tea bushes in order to obtain a license. This minimum hectarage figure is based on processing capacity requirements for a conventional one line tea factory. One of the arguments put forward for imposing minimum hectarage requirements is to guide investors on processing capacity, to safeguard quality, and to ensure that factories are able to operate at optimal capacity. However, these benefits could be realized through issuing industry guidance and recommendations rather than by imposing minimum requirements which may have a negative impact on competition as they create significant barriers to entry and may discourage innovation. Such operational considerations are fundamentally commercial in nature and it would be the responsibility of the private sector to determine how their factory will operate – with the incentive to operate at optimal capacity being provided by returns from the market from operating efficiently. Moreover, prescriptive recommendations such as these do not take into account changes in operating technologies over time, which mean the optimum hectarage or input of raw materials will also change over time, rendering such minimum requirements redundant at best, or suboptimal at worst.

In a positive move for the industry, the Tea Directorate of AFFA (formerly the TBK) has recently made progress on developing updated regulations which accommodate new technologies being adopted in the industry. In the most recent version of the Draft Tea Regulations of 2015, differences in technology have been taken into account in the case of license applications for the manufacture of high-value specialty or value added teas. For such specialty teas, the draft regulations allow the Tea Directorate to grant a license “based on economic viability, technology

\textsuperscript{54} The Ministry of Agriculture, Livestock and Fisheries has recently published a Draft National Tea Policy (May 2014). The policy has not yet been implemented and it outlines the government’s intended measures in the tea industry. The objective of the policy is “to make the Kenyan tea industry sustainable and globally competitive in order to enhance its contribution to the Kenyan economy and improved livelihoods through employment creation and increased incomes.”

\textsuperscript{55} Tea (Licensing, Registration and Trade) Regulations, 2008 Available at: http://www.teaboard.or.ke/opencms/export/sites/tbk/about/downloads/tea_regulations_2008.pdf; and Tea Directorate Regulations, 2013. This version is yet to be gazetted. Available at: http://www.teaboard.or.ke/opencms/export/sites/tbk/about/downloads/tea_regulations_draft.pdf
used, and/or the proposed range of products”. To further strengthen this provision it may be advisable to provide some guidance on the criteria that will be used by the Tea Directorate in assessing these factors. For example, it appears that in practice informal minimum hectarage requirements could be employed in this process, leading to a potential lack of clarity and certainty for potential investors over the conditions for application approval.

Furthermore, current draft regulations for the tea industry require growers to register with a single factory and mandate growers to sign a green leaf supply agreement (GLA) with that factory, meaning that growers may deliver green leaf only to the factory with whom they are registered. These requirements - as well as the condition (also contained in the draft regulations) that factories may only source green leaf from growers within a 50km radius - are intended to promote the efficiency and stability of vertical supply chains. For instance, in the case of the GLAs, the Tea Directorate states that such agreements are important for planning purposes for both the factory and the grower. However, they can also restrict the ability of farmers to obtain the best price for their product and affect the ability of factories, particularly new entrants, to source tea leaves. The Tea Directorate has sought to address such concerns in the current draft regulations by prescribing the form of the GLA in the draft regulations, and by providing that the parties are able to terminate the GLA with one month's notice. Nevertheless, one concern cited by industry players is that additional licensing conditions for specialty tea processors appear to go a step further than the above restrictions by prohibiting the processing of leaves produced outside their own farms.

**RECOMMENDATIONS FOR TEA**

- Since the tea market is contestable, it is recommended that market forces should be the key driver determining the allocation of resources in the sector. The involvement of incumbents in entry decisions may lead to distortions and a misallocation of resources.
- Review the tea regulatory framework, including the draft Tea Regulations and the draft National Tea Policy, to remove rules and licensing conditions for tea processors (including for specialty tea producers) which unreasonably restrict competition. Ensure proper implementation of the regulatory framework under the AFFA Tea Directorate.
- Review regulations which lock in growers with factories for an undetermined period of time.

**Sugar: Encouraging Productivity for the Benefit of Consumers**

The sugar subsector plays a major role in the Kenyan economy and is a source of income for millions of citizens. The industry supports at least 25 percent of the Kenyan population. Moreover, sugar companies and outgrower institutions assist in the development of schools, roads, and health facilities in communities (KSB, 2009).

However, Kenyan sugar production is considered inefficient and the country continuously runs a sugar production deficit. Currently, the high cost of production and taxation makes Kenya’s sugar subsector uncompetitive compared to other sugar producers within the COMESA region. Meanwhile, Kenya’s sugar consumption continues to grow and outpace production. According to US Department of Agriculture estimates, Kenya will continue to rely on imports to meet internal demand for sugar (USDA GAIN, 2013).

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Historically, the sugar industry has been subject to highly protectionist policies and heavy government involvement. Notwithstanding such constraining conditions, imports accounted, on average, for 26 percent of domestic production in the years preceding liberalization, which started in 2001 (Argent and Begazo, 2015).

After Kenya joined the COMESA Free Trade Area (FTA) in 2001, Kenya’s sugar market was expected to open up. Initially, due to high demand, cheaper sugar was massively imported from COMESA countries. However, the government quickly introduced a quota on COMESA imports. This policy has been extended throughout the years despite being initially envisioned to decrease gradually. The tariffs were scheduled to fall to zero in March 2014, but Kenya sought an extension until 2015 to provide more time for it to improve infrastructure and carry out other reforms. The Kenyan Government has, on several occasions, blocked COMESA imports due to various disputes, such as disagreements on the auction system to be adopted. The government has often imposed Non-Tariff Barriers (e.g. clearing fees and mandatory import permits for sugar) that made importing difficult. Import barriers have prevented imports, which would drive down the local price of sugar towards levels of the more efficient COMESA countries.

According to the Kenya Sugar Board data, government ownership in the sector remains as much as 37 percent of production in local factories (accounting only for controlling shares). As reported in Chisanga et al. (2014), government owned mills are the least productive. The sugar company with the least degree of state ownership (Mumias) holds the largest market share (38 percent) and appears to be the most efficient. In addition, state-owned companies bear higher costs that are mirrored in higher prices to consumers, which, on average, are higher than in other COMESA countries.

As reported in the regional sugar inquiry (Gathiaka et al., 2012), consumer prices for sugar in Kenya are higher compared to neighboring countries; the same is true for ex-factory prices. From Figure 14 it is clear that in the past decade there has been a common upward trend in ex-factory prices worldwide; however, prices in Kenya soared at a faster rate and have always remained above other African countries’ levels. In particular, it is interesting to compare Kenya’s prices to neighboring Tanzania where there are no import restrictions: in Tanzania, prices per ton, on average, are US$200 less than in Kenya.

**Figure 14: Sugar Ex-Factory Prices in Kenya, Tanzania, South Africa, Zambia, and the World (2002-2012)**

The USDA FAS reported: “In March 2010, The GOK suspended the 2008 sugar regulations on COMESA sugar auction ‘rights’. The new regulations led to a stand-off between government of Kenya and sugar importers, the court case that ensued locked out COMESA sugar between October 2008 and July 2009. The auctioning system faced several challenges with COMESA saying that it amounted to a non-tariff barrier.” (USDA GAIN, 2010).

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• Reduce government ownership in milling as this has been identified as one of the main sources of limited productivity and high prices.

Lowering prices through the removal of trade barriers and more efficient domestic production would have a significant effect on poverty. In particular, it has been estimated that a 20 percent price decrease in sugar would lead to an approximate 1.5 percent decrease in income poverty for Kenya overall and greater benefits for the poorest households (Argent and Begazo, 2015).

Agriculture Inputs: Reducing Market Distortions through a Revised Strategy of Governmental Commercial Activities and a Targeted, Market-Friendly Subsidy Program

This section focuses on selected input markets given their impact in the agriculture sector. As reported in the Agricultural Sector Development Strategy, 2010-2020 (see GoK, 2010) the major inputs in agriculture other than credit are seeds, fertilizer, pesticides, livestock feed, farm machinery, breeding animals, and building materials. Demand for inputs increased in the past years, especially for fertilizer, seeds and animal feed.

In Kenya, the usage of good quality seed and fertilizer remains low and has been facing a downward trend in the past few years. The use of improved seeds has remained low due to poor distribution systems. The use of fertilizer is low due to its high price, attributed to the high cost of transportation and distribution systems (GoK, 2010). Fertilizer use in Kenya is less than a third of the level reached in India and a quarter of the level in Indonesia (see Figure 15). In addition to the high cost, adulteration by merchants, which affects the quality of fertilizer, seed and pesticides, has limited the use of these inputs.

Subsidies are a tool adopted by governments to incentivize input usage and they can be designed in such a way as to limit market distortions. Agricultural input subsidies are a very common feature of agriculture development policies. Box 7 describes the purpose and risks associated with the design of subsidies in the input market.

The case of fertilizers

Fertilizer consumption in Kenya has remained stable in the past decade, with no improvements since the subsidy program was introduced. Fertilizer use in the past decade has been stagnant. Figure 16 below shows that fertilizer consumption in the past decade has hovered around 30 Kilograms per hectare of arable land. Moreover, it emerges that since the government started subsidizing fertilizer in 2008, consumption decreased. Furthermore, the gap between fertilizer consumption in South Africa and Kenya seems to have remained constant despite the subsidies imposed in Kenya.

Figure 15: Nutrient Use on Arable and Permanent Crop Area, 2005-2010

Source: FAO stat data

Figure 16: Fertilizer Consumption in Kenya, Zambia and South Africa, 2004-2010

Source: World Development Indicators
A subsidy is defined as a payment, generally made from public resources, that reduces the price that a buyer pays for a good or service below the price at which the seller provides it. The difference between the seller’s price and the buyer’s price is the amount of the subsidy (Takeshima and Lee, 2012).

Governments may be willing to subsidize agricultural inputs with the economic aim of increasing agricultural productivity, which may be linked to social policy objectives such as poverty reduction and food security. The purpose of such subsidies is therefore to allow farmers to access lower cost inputs (such as seeds and fertilizers). Reducing farmers’ costs and raising their productivity is expected to increase their incomes, which can be invested in better equipment, for instance.

However, when designing subsidies, one should not overlook the costs and the distortive incentives associated with the subsidy program.

First of all, subsidies are very costly for governments, especially when these are managed by bodies with limited efficiency, not subject to market forces, and prone to political capture. Therefore, optimal subsidies are designed, bearing in mind their opportunity cost (i.e., redirecting those public funds to investments with higher rates of return). Moreover, targeting subsidies at more vulnerable groups is often complicated. Hence, subsidies may heighten inequality by mainly benefiting the larger farmers rather than small-scale farmers or subsistence farmers.

In addition, improperly designed subsidies may distort the private sector input market, artificially driving the market price down and preventing the private sector from competing with subsidized products on a level playing field. Low costs may also induce farmers to overuse, or switch to inefficient input-intensive production systems.

There are situations where inputs can be productively subsidized, but they need to be carefully identified and the subsidy program should be temporary and have a clear exit strategy. For instance, breeding of new crop varieties is usually an activity carried out by the government. Properly designed subsidies can help temporarily address market failures and minimize distortions on the market.

Governments, moreover, might consider adopting less distortive tools to support farmers’ income. For instance, governments might encourage and support farmers to team up in order to enjoy the benefits of bulk purchases of inputs. Alternatively, the government could set up a demand-side voucher system in order to provide for subsidized inputs. If properly administered, such schemes are generally less distortive of market systems than direct subsidies since they provide consumers with a greater degree of choice in terms of choosing their suppliers and allow supplier outcomes to be better linked to performance. This has proven successful in some other countries.\(^{58}\)

Source: Seini et al. (2011); World Bank (2004); Takeshima and Lee (2012)

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\(^{58}\) See the example of the United Republic of Tanzania (2014) for a study on the National Agricultural Inputs Voucher System implemented, and Mangisoni et al. (2007) for results in Malawi, Mozambique and Zambia.
Historically, fertilizer has been subsidized in Africa; although in recent years the market has undergone some liberalization reforms. In most of Africa, fertilizer subsidies began in the 1960s and 1970s. These programs were typically implemented through government-owned corporations that were given a monopoly on fertilizer and they sold fertilizers at below market prices. Structural Adjustment Programs (SAPs) helped the liberalization of the fertilizer market in Kenya. In the early 1990s in Kenya, there were only few fertilizer importers; fertilizer prices were decontrolled to encourage a private-sector-led market for fertilizers. In 1993, import licensing quotas and foreign exchange controls were eliminated.

Since 2008, the government has put in place a fertilizer subsidy scheme, run by the National Cereals Produce Board (NCPB). Since 2002, the NCPB has diversified into the marketing of various agricultural inputs, such as fertilizers, as part of the strategy of enhancing efficient cereal production through the use of affordable quality inputs. Since 2008, it has been asked by the government to import and distribute fertilizer at a subsidized rate.

Farmers can purchase a part of their fertilizer requirement from NCPB at a subsidized rate – the remaining part is purchased from the private sector. NCPB purchases fertilizer from international traders and uses its wide network to distribute it to farmers. Farmers can access fertilizer at a subsidized rate by applying to the Ministry of Agriculture, which sends an agricultural officer to evaluate the fertilizer needed, specific to the land. The officer will then fill out the relevant form which the farmer must hand to NCPB depots to buy the fertilizer at the subsidized rates. The remaining part of fertilizer requirement is purchased from private sector importers.

The system, however, presents some shortfalls and it has been criticized by stakeholders. Stakeholders argue that the subsidy program in place is very inefficient. They claim that NCPB uses numerous intermediaries, both upstream and downstream, making the procurement and distribution process inefficient, slow, and costly. Inefficient distribution leads to inadequate and untimely application of fertilizers, which hampers productivity. Indeed, late distribution and inadequate access of subsidized fertilizer was identified by the Ministry of Agriculture as one of the challenges to food security in 2013.99 Another reported weakness of the current subsidy system is the fact that distribution criteria are not clear and transparent; therefore, supply might be prone to diversion and leakages or reach large-scale farmers before reaching small and subsistence farmers. This implies that there may be some displacement of commercial sales which would otherwise be made to farmers who would have been able to afford fertilizer in the absence of the subsidy.

The government is working to develop fertilizer manufacturing plants within Kenya that will compete with the private sector. In an effort to make fertilizer more affordable and easily accessible to farmers, Vision 2030 envisages a three-tiered cost reduction strategy. One of these three tiers is the local manufacturing of fertilizers. In February 2015, Toyota Tsusho was awarded a contract to establish a fertilizer manufacturing plant in Kenya, following negotiations held by the Ministry of Agriculture with Toyota Tsusho and the other shortlisted bidder in the process, Marubeni Corporation.60 The first phase is expected to be completed by 2016 with production of the first batch of Nitrogen, Phosphorous, and Potassium (NPK) fertilizers. The viability of such project has been heavily questioned. Importers argued that conditions in Kenya are not apt for fertilizer manufacturing due to extremely high energy

costs, limited infrastructure, and no raw materials available domestically. Maintaining the openness and contest ability of the fertilizer market, even when the government fertilizer plant begins operation, and ensuring competitive neutrality would be essential.

The performance and pricing ability of importers in the private sector seem to be highly affected by NCPB’s role in the market. Usually, farmers wait to purchase the subsidized fertilizer, and only then do they subsequently turn to the private sector to purchase the remaining fertilizer need. In the private sector, there are thirteen main importers. There is no ownership restriction and entry is relatively easy as there is no licensing requirement for importers. However, the importer must register with the Kenya Revenue Authority (for payment of tariff purposes) and must comply with the quality standards set by the Kenya Bureau of Standards (KEBS). All shipments that do not have a pre-export verification of conformity must undergo inspection by KEBS at the port of Mombasa since there is no risk-management system to optimize inspections. Economic barriers to entry might be more significant for distribution given infrastructure needs. It is worth noting that the CAK is currently conducting a sector inquiry into fertilizers to assess the level of competition in the market, identify competition issues, and propose specific recommendations.

### RECOMMENDATIONS FOR FERTILIZER

The analysis presented in this section highlighted the weaknesses of the current subsidy scheme in Kenya. In a market where awareness of fertilizer use is very low among small-scale farmers, it might be necessary for the government to undertake subsidy programs so as to promote the use of fertilizers. However, there might be more efficient options that exploit competition among suppliers to the benefit of farmers and consumers. They include:

- **Progressively removing reliance on the NCPB for subsidized fertilizer.** Centralizing procurement into one body might be economically rational in order to achieve economies of scale; however, contracting the purchase and distribution of fertilizer to the NCPB has presented challenges. Instead, the government may wish to consider allowing the private sector to participate in the importation and distribution of inputs. However, in this scenario it would be crucial that contracts for distribution are competitively and fairly awarded to private firms through competitive bidding procedures.

- **Evaluating the introduction of a voucher or coupon system,** whereby farmers can procure fertilizer at a subsidized rate from the private-led market. More efficient distribution systems might lead to reduced costs for the government and benefit farmers. They would also allow for a further development of the market and agro-dealer network, in addition to better targeting those farmers who would not otherwise buy fertilizer commercially.

### The case of the seed industry

The seed industry in Kenya has experienced considerable changes over the past years in terms of regulatory framework, market liberalization, and policy reforms. The first seed company, Kenya Seed Company (KSC), was established in 1956 as a government entity. The sector experienced partial liberalization in the 1980s and a further opening in the 1990s. There are currently 116 registered seed companies, although only a few control a large share of the market (CAK, 2014b). Figure 17 shows that Kenya has registered the lowest seed prices in the COMESA region over the past years.
In Kenya, the government is highly involved in seed production through public research institutions and seed production institutions. Even though the sector has undergone full liberalization, breeding and production institutions, such as the Kenya Agricultural Research Institute (KARI) and KSC, enjoy a considerable level of government support. The market share of KSC and related companies in maize seed is around 79 percent, 28 percent in sorghum, and 49 percent in beans. According to the sector inquiry produced by the CAK in 2014, the NCPB’s tenders for subsidized inputs seem to favor public seed companies, potentially reducing the level of competition in the market. Moreover, government participation in the sector has influenced the relationships between market players along the value chain. For example, new seed varieties bred by public research institutions such as KARI used to be licensed to a single public-owned seed firm. Given the strong dependence of the seed industry on scientific innovation, these practices are likely to alter the level playing field by creating discriminatory conditions amongst market players. Furthermore, seed companies with state participation also benefit from the use of NCPB’s distribution and warehousing network.

Prices of seeds sold by public companies are highly subsidized; a condition that is likely to alter the level playing field amongst market players. The leading maize seed company is publicly-owned and offers stocks of seeds for about KSH 280-320 per kilogram, while private dealers sell at KSHS 300-350 per kilogram (CAK, 2014b). Even though industry players agree that seeds are currently not a major cost for famers compared to fertilizer, agro-chemicals, labor, transport and energy costs, voucher schemes would be preferred to subsidies (see Box 9).

In parallel, the regulatory framework can be strengthened to encourage private sector participation. Rules seem to limit the ability of firms to expand and increase their variety of products. The current compulsory seed certification scheme could be evaluated based on successful experience in other countries where quality declared seed is allowed. The length of procedures for national performance trials and distinctness, uniformity, and stability testing for variety release could also be reviewed. The new seed regulations are expected to address these issues.

**RECOMMENDATIONS FOR SEEDS**

- Reduce government intervention in the market since it is likely to negatively affect the level of competition by altering the level playing field. Although government support to Research and Development (R&D) activities can be beneficial, reserving new seed varieties for public seed companies may unduly alter

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61 Other public seed companies include: Egerton University Seed Unit; Kerio Valley Development Authority; Lake Basin Development Authority; Mwea Irrigation Agricultural Development (MIAD); Maseno University, Agricultural Development Corporation (ADC); University of Nairobi Seed Unit (Uniseed); and Simlaw Seeds (CAK, 2014b).

competition and prevent the full exploitation of the initial investment. Government tenders for licensing new varieties should be transparent and open to all seed companies.

- **Consider the introduction of a voucher coupon system** for maize seed supply as an alternative to the subsidies currently in place (see Box 9).
- **Update the regulatory framework in the seed sector** to facilitate private participation and expand production of quality seed.

### The case of the artificial insemination industry

Artificial insemination (AI) was introduced by the GoK in 1940 as an element of the dairy value chain and the service is now provided by private inseminators. It is currently considered the most important approach to breed improvements, allowing a small portion of top performing bulls to be available in multiple places at the same time. The AI sector has experienced a growing trend, with inseminations reaching 542,000 in the late 70s. Until 1991, the industry was public-sector run; mismanagement and budgetary constraints led to privatization in 1991. Today there is no AI service delivery by the government and the service is provided by about 1,000 licensed private inseminators (CAK, 2014a).

Although facing a downward trend, government intervention in the artificial insemination sector is still significant. According to the market inquiry conducted by the CAK in 2014, local production of semen is controlled by one publicly controlled producer, the Kenya Animal Genetic Resources Centre (KAGRC), previously known as the Central Artificial Insemination Station (CAIS). The KAGRC has the mandate to produce, preserve, and conserve animal genetic material (semen embryo, tissues and live animals) and rear breeding bulls for provision of high quality disease free semen to meet the national demand and for export. Although there is nothing in policy that prevents entry of new producers, the risks of competing with a government-owned, highly-subsidized producer have so far dissuaded private businesses to invest. This trend has recently started to change and the CAK (2014a) confirms that there are at least five local private sector organizations that have expressed interest in investing in bull semen production, and at least two of these firms have been licensed. Still, according to the market inquiry, discussions with prospective investors have indicated that government subsidies to KAGRC represent the biggest threat to their business plans. KAGRC is also responsible of assuring quality of imported semen. This might create a conflict of interest since KAGRC might have an incentive in denying clearance to semen importers on the basis of quality.

### Recommendations for Artificial Insemination

- **Ensure competitive neutrality between KAGRC and private producers.** A level playing field would encourage private sector participation and expand the provision of artificial insemination, which in turn can increase productivity in the livestock sector.
- **Increase transparency of the quality standards for semen, and reduce discretion in clearing imports.** In addition, separate the regulatory and commercial functions of KAGRC, and mitigate conflict of interest of KAGRC in clearing its competitors’ imports of semen.
- **Publish legislation and guidelines** to open up the space to private sector investment and facilitate the process of investment (CAK, 2014a).

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2.2 ELECTRONIC COMMUNICATIONS

Telecom Services

Product market regulations in the telecom sector appear to have failed to foster a market structure more prone to competition. In this sector, Kenya registers a PMR score higher than the OECD average, and one that is joint second highest with India and below only to Costa Rica (Figure 18).

The OECD regulatory indicators show that the existence of concentrated markets appears to be the main problem for the telecommunication sector in Kenya.

- The market share of entrants in different segments of the telecommunications market is low. For domestic fixed-line telephony, there are three entrants that hold less than 3 percent of the number of lines. For international-fixed line telephony, there is one new entrant, Wananchi Group Ltd, with a market share of 0.7 percent. For the mobile telephony, there have been two new entrants in recent years, Airtel Networks Kenya Ltd (which held around 9.8 percent market share in voice traffic as of December 2014) and Essar Telecom Ltd. which subsequently exited the market in January 2015.

- In Kenya, there is only one main provider for fixed-line services, Telekom Kenya. All in all, fixed-line network and service providers in the country are four. A market characterized by a single provider is likely to present underlying regulatory concerns. Nevertheless, because of the relatively low importance of the fixed-line telecommunication market in the Kenyan economy, this report will not drill down on this segment. Stakeholders’ interviews confirmed that fixed line telecommunications have been overcome by mobile communications in Kenya.

The main regulatory body for telecommunication in Kenya is the Communications Authority of Kenya (CA). Within its mandate, the CA is in charge of fostering competition and safeguarding against anticompetitive behavior.

Figure 18: PMR Score for the Telecom Sector (2013*)
(Scale is 0—6, from least to most restrictive of competition)


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64 In 2007, France Telecom won the bid for 51% of the shares of Telkom Kenya, paying US$390 million. See IFC short summary, at http://www.ifc.org/wps/wcm/connect/b5306380498391cc8614d6336b93d75f/SuccessStories_Telkom.pdf?MOD=AJPERES

by licensed operators. In the past years, the CA has worked to liberalize the telecommunication sector as a whole. This has helped to dramatically increase telephone penetration, especially for mobile services.

In Kenya, consumers have developed a stronger preference for mobile telephones. Mobile subscriptions are constantly increasing, while the opposite is true for fixed telephones. According to the 2013/2014 Global Competitiveness Report, there are 71.9 mobile telephones for every 100 inhabitants in Kenya. The same statistic is significantly different for fixed-line telephones, where only 0.6 of every 100 inhabitants have a fixed line subscription (World Economic Forum, 2013). These estimates are confirmed by the CA Quarterly Sector Statistics Report of October/December 2013. On the one hand, mobile telephony subscriptions marginally increased during this quarter, from 31.301 to 31.309 million. Mobile penetration during the quarter remained steady at 76.9 percent, while local mobile voice traffic registered an upward trend, growing by 5.5 percent. On the other hand, the fixed line market continued on its downward trend, recording a 1.7 percent decline in subscriptions.

It is worth mentioning that telecommunications providers are increasingly facing competition from ‘over-the-top’ services and this will also shape competition in the market. Apps that enable instant messaging and voice communication via data plans compete directly with SMS and voice services delivered by telecom operators. In a recent survey in Europe, both telecom operators and stakeholders identified competitive pressure from over-the-top services as one of the top two greatest challenges that will be faced by mobile operators over the next five years. In this context, policy-makers are testing paths to balance innovation, investment, and competition in the ICT sector, and Kenya is no exception. The broader scope of the CA’s mandate (including broadcasting, multimedia, telecommunications, and electronic commerce) allows implementing policies to boost the performance of the whole ICT sector.

Mobile Telecom Market: Reducing Consumer Switching Costs

Until recently, four private mobile telecommunications companies—Safaricom, Airtel, Telkom Kenya (Orange), and Essar Telecom—operated in Kenya. Concentration in the market has increased in the last three years in terms of subscriptions, voice traffic, and SMS (Figure 19, left). Concentration in SMS is the highest with Safaricom handling 96 of the traffic. In terms of market share, according to the CA Quarterly Sector Statistics Reports, Safaricom recorded the largest market share in terms of voice traffic (79 percent for 2014), Airtel followed with 11 percent, Essar Telecom registered 7 percent market share, and Telkom Kenya (Orange) recorded 3 percent market share. However, in January 2015, Essar exited the market through a sale of its assets to Safaricom and Airtel. After the announcement of Essar’s exit, the market share of Safaricom, in terms of voice traffic, increased; in the last quarter of 2014, it recorded 84 percent market share (Figure 19, right).

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70 For more information on regulation of ‘over-the-top’ services, see the ICT Regulation Toolkit, produced by the Information for Development Program (infoDev) and the International Telecommunication Union (ITU), available at http://www.ictregulationtoolkit.org/2.5.1
71 Figures calculated based on various quarterly report available at http://ca.go.ke/index.php/statistics
72 CA Quarterly Sector Statistics Reports.
Overall, tariffs have been decreasing in recent years, both for voice services as well as for SMS, partly due to the mobile interconnection rate glide path set by the regulator in 2010. In 2014, voice traffic grew by 2.3 percent over 2013 and SMS sent increased by 14.9 percent. In the mobile segment, operators are encouraging competition by offering competitive tariffs. For example, Airtel introduced a tariff that bundles voice, data, and SMS for a fixed price, which was followed by a gain of 0.6 percent in market share.

Competition is expected to be further encouraged by the recent entry of three Mobile Virtual Network Operators (MVNOs): Finserve Africa, Zioncell Kenya, and Mobile Pay. Indeed, empirical evidence from other countries shows that customers often benefit from the entrance of MVNOs in the telecommunication market, through lower prices for voice calls and text messages (Kiiski, 2006). MVNOs will run on the networks of existing operators but will be independent in providing services, including SIM cards issuance, billings, and customer care. During the April 2014 press conference, the Director General of the CA confirmed that “MVNOs will have a chance to come up with innovative ways to make them have a competitive advantage over other players in the sector. It is going to be good to the consumer in terms of quality and affordability. As we go forward, we will expect lower call rates and greater innovation and improved services.”

Notwithstanding the progress made so far in this segment, there is some room for improvement regarding consumer mobility between providers. The CA Quarterly Report states that the performance of mobile number portability is hampered by counter-strategies from operators, who have set up strategies to raise switching costs. By 2013, number portability was available in 94 countries worldwide. The economic literature shows that number portability has a positive impact on consumers, as companies adjust their strategies to improve consumers’ fidelity (for example, by lowering prices and providing additional services). Cho et al. (2013) study the effects of number portability in Europe and, using quarterly data from 47 mobile carriers in 15 European countries between 1999 and 2006, show that portability has intensified competition, leading to an increase in consumer surplus. In particular, across European countries, the introduction of mobile number portability has decreased prices by 7.9 percent on average, increased competition by reducing the incumbent’s market power and tightening the range of prices practiced, and increased consumer welfare.

73 CA Quarterly Sector Statistics Reports.
In Kenya, during the time-span analyzed in the report, number portability operations declined by 24 percent, reflecting some challenges in the portability process. Number portability was introduced by the end of 2011 and was expected to have great impact on competition. One of the main regulatory problems with number portability in Kenya is that the administrative cost of the service is borne by the porting consumers. Subscribers wishing to port their numbers from one operator to another are expected to pay a porting fee of 200 shillings, equivalent to 57 percent of a month’s credit. Imposing a monetary burden on porting consumers creates disincentives for switching operators in the first place. Furthermore, while the CA works to guarantee that consumers are never left without a working number and advertises the easiness of the porting process (see Figure 20, a flier of the CA campaign), the process presents some challenges in practice. Local stakeholders pointed out that the number portability service is not immediate and consumers are likely to be left without a working number for up to 48 hours; this is likely to further restrain the willingness of consumers to switch.

Figure 20: CCK’s Number Portability Advertising Campaign “This is my number”

Recommending for telecommunications:

- Reassess the value of the porting fee and consider eliminating the porting fee currently imposed on porting consumers. Porting fees are imposed by operators to cover the administrative costs they suffer for granting the number portability service. While it is appropriate that firms are able to cover the costs they incur to provide their services, including the portability service, from a social welfare point of view, it might be undesirable to impose these costs univocally on consumers that decide to switch. Indeed, switching consumers generate a positive externality on other consumers, as they trigger the competitive process that leads to lower prices or other beneficial commercial conditions for all consumers. It follows that, from an economic point of view, it would be socially more efficient if the administrative costs of number portability were covered by the prices that firms charge for their services to all consumers. Moreover, the alleged administrative cost of 200 shilling seems disproportionate when compared with the cost of a one minute phone call from a Safaricom pre-paid phone (KSH 1.00) and may create artificial barriers to switching.

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78 Mobile number portability procedure, CCK: “To start the automated porting process subscribers will need to send the word PORT or HAMA to 1501 using their existing SIM card. The subscriber will then receive an SMS from PORTING bearing either of the following information: Thank you for your SMS. Your porting request is being processed; OR your porting request has failed. Please contact your new Operator. When the automated switching process is complete, one will receive, within a few minutes (but not longer than 48 hours), an SMS from PORTING bearing either of the following information: This Account will be closed soon. Please use your SIM card from your new Operator. OR Porting Error. Please contact your new Operator”.

79 Ideally, porting fees should be eliminated. A less efficient alternative consists in imposing cost-based porting fees. This latter solution is not the first best option, but it does represents an improvement from the current set-up.

80 See Uwezo tariffs on Safaricom website at http://www.safaricom.co.ke/personal/prepay/prepay-tariffs
• Automate the switching process, guarantee that consumers are never left without a working number during the switching process, and allow customers to transfer their balance onto the new SIM card. Eliminating any regulatory refrain to switch is fundamental, given that switching consumers are beneficial to the competitive process, as described above.

Spectrum Allocation: Preserving Competition through Updated Spectrum Management

Kenya lacks a market-oriented process for spectrum assignment, and this could become a challenge in the current scenario where new available spectrum will be assigned. There are two main policy options for spectrum allocation and assignment. The first alternative follows a command and control approach. In this model, the regulator sets up detailed rules that effectively determine how, where and when the spectrum can be used and who has the right of access to the spectrum. The second alternative follows a market-oriented method. Spectrum is a profitable resource and, as such, is allocated and assigned through market forces. In this scenario, spectrum allocation and assignment is thus decided by the market; for example, through auctions or other competitive selection processes. Furthermore, this second alternative usually grants market players the right to trade the spectrum over the lifetime of the license. The digital switchover will free up valuable spectrum and thus, having in place the appropriate assignment rules is key to safeguard future competition in the telecommunications sector.

In Kenya, the Communication Authority (CA) is vested by law (Kenya Information and Communications Act 2006) with responsibility for managing the frequency spectrum. It follows that only the CA has the statutory power to assign the spectrum (to broadcasters, mobile operators, and others) and to revoke licenses when deemed necessary. The licensing assignment process is determined by a committee within the CA, the Communication Licensing Committee (CLC), which has the discretionary power to decide upon the final outcome of the spectrum allocation process. The CLC deliberations are not publicly available, and information on spectrum assignment is only available at the condition of paying a fee.

Encouraging effective competition is the best way to promote ICT development and consumer accessibility in the sector, and policies in the sector will benefit from embracing this principle. In a world of wireless communications, access to spectrum is key to drive competition. Network quality, determined by access to spectrum, emerged as the most popular dominant form of competitive differentiation employed by mobile operators. The Ministry of Information, Communications and Technology has acknowledged the importance of updating spectrum management practices in order to foster growth in broadband networks. To tackle this, the ministry has recently drafted the Wireless Broadband Spectrum Policy guidelines, currently under review by stakeholders. The draft policy establishes principles for spectrum management, which comprise fostering competition, growth and innovation in the use of spectrum, encouraging spectrum to move to its highest value, and easing access to spectrum, among others. It also states that market mechanisms may be appropriate where the use of spectrum is directly subject to market forces (e.g., provision of electronic communications services), while the regulator may use other

82 According to the CCK 2008-13 Strategic Plan: “The CLC is a standing committee set up by the Commission’s Board of Directors, in accordance with clause 13 of the Act, to assist in vetting and evaluation of license applications. The CLC draws its membership from LCS, CTMA, FSM, Legal, F&A and representatives from the Office of the President”.
83 Telecoms.com Intelligence (2014).
mechanisms as appropriate where the use of spectrum is not subject to market forces or where it is required for the provision of security, social, cultural objectives.\textsuperscript{84}

Notwithstanding the progress made in terms of defining principles for spectrum management, the regulatory framework for allowing a pro-competitive mechanism to assign spectrum for advanced mobile technologies is not yet in place. Indeed, Safaricom, Kenya’s first provider of 4G Internet services, obtained the spectrum through direct assignment. Safaricom signed a 15 billion shilling (US$166 million) agreement with the government in December 2014 to build a national security and surveillance system and was offered the rights for 4G radio spectrum as part of the agreement.\textsuperscript{85} In the future, a more structured and predictable process for creating PPPs that involve spectrum or any other public resources would be advisable; this could be part of Kenya’s PPP framework. Competitive selection of the private partner is advisable to guarantee that government contributions (in terms of assets, investment, value of land, spectrum, and others) are calculated correctly and serve only to allow the operator to function and provide services within an “economic equilibrium” when operations are not viable without the grant. PPPs have the potential to affect competition by strengthening the private partner’s position in the market and this should be considered when designing a PPP.

Clarity on the broadband policy is also needed regarding the proposal of operationalizing a single wholesale provider under a public-private partnership, given its expected impact on competition. The draft Wireless Broadband Spectrum Policy supports the deployment of a mobile broadband network under a government-led initiative and recommends a PPP approach to deployment. In particular, government contribution may be limited to contribution of spectrum and licenses in accordance with the agreement with the private sector partner(s), while private sector participation on the other hand, may involve capital contribution among other resources.\textsuperscript{86} However, the draft policy rightly recognizes that “the roll out of the network is likely to face various challenges that include inadequate policy and regulatory framework to address issues of operation, performance obligations, coverage, and governance structure among others. It could also potentially undermine the role and influence that the current operators have in the market.” The final Wireless Broadband Spectrum Policy Guidelines should be adjusted to maintain consistency between the principles for pro-competitive spectrum management and the proposed PPP for a single wholesaler of wireless broadband.

**RECOMMENDATIONS FOR SPECTRUM ALLOCATION**

- Design a spectrum assignment mechanism that boosts competition in the sector. It is advisable that the CA carefully designs any tender for mobile spectrum assignment and works together with the CAK to get inputs to support a pro-competitive process. Generally speaking, a market-based approach for spectrum assignment is preferred to assigning all contenders an equal proportion of the available spectrum, as the former option fosters competition. Nevertheless, some considerations shall be taken in to account. While it is true that, on the one hand, tenders and auctions assign proportions of spectrum on the basis of the efficiency of contenders, on the other hand, the risk is that dominant companies in the market might abuse their position and acquire more spectrum than necessary. This is where the role of competition authorities becomes

\textsuperscript{84} ibid.
crucial: while promoting the market based approach, the CAK shall monitor any tender procedure as to prevent dominant companies from adopting anticompetitive foreclosing strategies. Considering the situation in Kenya, where Safaricom holds more than 70 percent of market share for mobile services, introducing a pure market-based approach for spectrum assignment could indeed have the potential of distorting competition in the market. However, various regulators have established rules to incorporate information on market structure to design specific tenders; this has been the case in Colombia where the competition agency provided inputs on tender documents to ensure competition in the 4G spectrum auction process and in the mobile internet market. Similarly, throughout a number of OECD countries, to assure the fairness of auctions, caps are imposed on the amount that participants are permitted to acquire in the auction.

- Define a wireless broadband policy that is consistent with the objective of promoting competition and access.

Mobile Payment System: Increasing Consumer Options

Reliable and efficient payment systems are pivotal for a proper functioning of the economy and the markets. When payment schemes are not well-designed, market participants are likely to be discouraged from engaging in market transactions. Costly systems are likely to deter consumers, particularly if the cost of participating in market activities outweighs the benefit. Given the critical role they play as well as their network characteristics, payment systems are often regulated. In Kenya, the Central Bank of Kenya (CBK) is vested with this task. The National Payment System Act 2011 provides that “the Central Bank shall, in the exercise of its role of formulating and implementing such policies as best promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems.” In particular, the objective of the CBK is to ensure that the payment systems (i) do not generate high level of risks to participants and users of financial services; (ii) continue to operate without major disruptions; (iii) offer efficient, reliable and safe payment services to customers; and (iv) have the necessary and regulatory legal framework.

The most popular payment system in Kenya is mobile payment. Figure 21 compares the evolution of the value of mobile payments transactions with that of card payments in Kenya. Besides a brief period in February 2013, the value of mobile payments transactions has steadily been higher than that of card payments. Interviews with local stakeholders also confirmed that mobile payment is the preferred payment system in Kenya, being the cheapest and most reliable. The first mobile payment system to be launched was the M-PESA system, sponsored by Safaricom in 2007. By September 2014, M-PESA had a market share of 74 percent in terms of subscriptions and almost 70 percent in terms of the number of agents affiliated with the network. These figures are likely to underestimate the share of the market held by M-PESA in terms of volumes or value of transactions since in some cases, individuals subscribe to multiple mobile

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88 This is the case in Australia, Canada, Czech Republic, Denmark, Estonia, France, Germany, Greece, Italy, Norway, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey UK, US. For a schematic review of auction systems designs in OECD countries, see http://www.oecd.org/sti/broadband/2-13.pdf
90 Card payments include: ATM cards, pre-paid cards, charge cards, credit cards, and debit cards.
payment services but use one more frequently than the others. By 2013, M-PESA was used by over 17 million Kenyans, and circulated 25 percent of the country’s GNP. M-PESA works as an electronic payment and stored value system, available and accessible from mobile phones. It allows customers to deposit or withdraw cash on their account, exchanging money for electronic credit. Customers can use their balance to transfer funds to other users on the same network, as well as to non-registered customers, and pay bills.

Safaricom’s M-PESA currently holds the majority of market share for mobile payment systems in Kenya, although the competitive pressure in this market has recently increased. Safaricom’s position has recently been challenged by Airtel, its main competitor, who in 2014 filed a complaint with the CAK asking it to probe Safaricom for abusing its market-leading position by entering into exclusive contracts with mobile payment agents, which prevented them from offering cash deposit and withdrawal services for other network operators. In July 2014, the CAK entered into a settlement agreement with Safaricom, with the latter undertaking to open up the M-PESA agency to the market players. Moreover, Safaricom’s position has also been challenged by Equity Bank, which obtained a Mobile Virtual Network Operator (MVNO) license through its subsidiary Finserve Africa (Equitel), and recently started to offer the service. The importance of Equity in financial services for small and medium enterprises could allow them to generate competitive pressure in mobile financial services and money transfer. Comparing tariffs from February 2014 with those from August 2014, Table 4 shows a recent decline (August 2014) in M-PESA prices for low transaction ranges, although significant increases in tariffs were also seen for higher transaction values.

**Table 4: Percentage Change in M-PESA Prices (February 2014 vs. August 2014)**

<table>
<thead>
<tr>
<th>Transaction range (KSH) [min-max]</th>
<th>Transfer to another MPESA user (% Change in Fee)</th>
<th>Transfer to non MPESA user (% Change in Fee)</th>
</tr>
</thead>
<tbody>
<tr>
<td>10-49</td>
<td>-67%</td>
<td>-</td>
</tr>
<tr>
<td>50-100</td>
<td>-40%</td>
<td>-</td>
</tr>
<tr>
<td>101-500</td>
<td>-59%</td>
<td>-33%</td>
</tr>
<tr>
<td>501-1000</td>
<td>-55%</td>
<td>-27%</td>
</tr>
<tr>
<td>1001-1500</td>
<td>-24%</td>
<td>-12%</td>
</tr>
<tr>
<td>1501-2500</td>
<td>21%</td>
<td>11%</td>
</tr>
<tr>
<td>2501-3500</td>
<td>67%</td>
<td>25%</td>
</tr>
<tr>
<td>3501-5000</td>
<td>82%</td>
<td>26%</td>
</tr>
<tr>
<td>5001-7500</td>
<td>36%</td>
<td>14%</td>
</tr>
<tr>
<td>7501-10000</td>
<td>55%</td>
<td>18%</td>
</tr>
<tr>
<td>10001-15000</td>
<td>73%</td>
<td>18%</td>
</tr>
<tr>
<td>15001-20000</td>
<td>82%</td>
<td>19%</td>
</tr>
<tr>
<td>20001-35000</td>
<td>34%</td>
<td>10%</td>
</tr>
<tr>
<td>35001-45000</td>
<td>34%</td>
<td>-</td>
</tr>
<tr>
<td>45001-70000</td>
<td>0%</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: World Bank elaboration based on M-PESA data.

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Government authorities are interested in improving the regulatory framework to encourage greater competition in payment systems. The CAK, in coordination with CBK and CA, is currently carrying out a study to encourage greater access to mobile payment systems, by analyzing fair pricing policies and promoting a greater role of the authorities in issuing individual Unstructured Supplementary Service Data (USSD) codes used by financial entities to provide mobile services. Preliminary analysis has been conducted on the need to promote interoperability and to support price awareness and price comparison. The collaboration agreement signed between the CAK and CBK in July 2014, as well as the agreement between the CAK and CA, signed in May 2015, will facilitate government coordination to generate a regulatory framework that encourages competition and boosts further expansion of the market, to the benefit of consumers.

Payment systems are a classical example of two-sided markets. In these markets, each firm has to attract two distinct groups of customers in order to be viable. The two groups are merchants, on the one hand, and buyers, on the other hand. Each payment system provider creates a platform that allows these two groups of customers to interact. An important feature of these markets is that customers of one of the two sides that join the platform generate positive indirect network externalities on customers of the other side. Indeed, if more merchants join a payment system, this becomes more valuable to the buyers that belong to the same platform because they can use the payment system in a larger number of outlets. Similarly, if the number of buyers that participate in a platform increases, the platform becomes more valuable to the merchants, who can interact with a larger number of potential buyers.

Because of these network externalities, in two sided markets the incumbent enjoys a significant advantage over its competitors and may obtain an entrenched market power. Two-sided markets tend to be highly concentrated with one firm usually dominating the market. Smaller rivals or new entrants have great difficulty in challenging the market position of the dominant company as they have to attract the two groups of customers simultaneously. Two measures can largely improve the competitive scenario: imposing interoperability among the various payment platforms, and impeding any restrictions on the ability of the two groups of customers (both merchants and buyers) to participate in more than one platform (so called multi-homing).

From the point of view of competition, one of the problems characterizing the mobile payment market is the lack of actual full interoperability in person-to-person transfers among the different mobile payments providers present in Kenya. Lack of full interoperability is considered a key reason for the large market share enjoyed by Safaricom, the incumbent of the market. Competition in the market is also limited by a lack of interoperability at the technological level. For example, M-PESA is delivered through SIM specific technology. In this way, the mobile banking application is specific to the particular network operator providing the SIM. This not only affects competition in the mobile payments market but also in the voice market by allowing the leveraging of market power between payments and voice markets. From a competitive point of view, lack of interoperability increases switching costs for consumers to choose a mobile payment service provider independently of their network provider, or switch between voice providers, impeding their ability to choose. Furthermore, if switching costs are high enough, entry conditions are likely to discourage potential competitors from challenging the incumbent’s market position.

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A potential solution to this issue is to allow third party access to a network’s mobile communication channels, particularly the USSD channel. Parties who do not possess their own mobile communications channel (as well as those who operate only a small network), and who wish to enter the mobile payments market, rely on being able to use the mobile networks of Mobile Network Operators (MNOs). When those MNOs are also active in the downstream mobile financial services market, this can cause competition issues. The MNOs may then have an incentive to either deny access or grant access to their downstream competitors only at a very high price. In these cases, telecommunications regulators may have an important role to play in ensuring that MNOs who are also active in mobile payments provision do not unfairly deny access to their mobile communications channel to any other party who requests it. The regulator can also help to ensure that access is granted on non-discriminatory and cost-oriented terms. To assess this issue further, a forthcoming study by the CAK aims to understand how third party access to the USSD channel can be facilitated. In addition to the USSD channel, it should be noted that there are other technological solutions to the issue of ensuring third party access to communications channels, such as “thin-SIM” technology. These are also worthy of further examination by regulators to understand the costs and benefits of their use.

Another competition concern in the mobile service market relates to exclusive contracts between operators and cash merchants, which prevent multi-homing on the merchant side. Exclusive contracts would likely create discriminatory conditions between mobile payment service providers by favoring an operator over another. In Kenya, the CAK advised that exclusive contracts between mobile money service providers and cash merchants may have anticompetitive effects and therefore, the CBK shall consult the CAK when assessing contracts, which must be submitted by service providers and are subject to the CBK’s approval. In Tanzania, for instance, the Central Bank, which is the relevant regulator, forbids exclusive contracts between mobile payment operators and agents.

Finally, recent studies have found that limited transparency on the costs borne by users of mobile payment systems limits effective competition (Mazer and Rowan, forthcoming). Although there is higher price transparency at the point of cashing in and cashing out (agents display tariff boards), users sending money via mobile services generally are not aware of the cost of the transaction. Therefore, consumers cannot easily compare the offerings of alternative providers and incentivize competition on prices.

**RECOMMENDATIONS FOR MOBILE PAYMENT SYSTEM**

- Develop mechanisms to facilitate interoperability between mobile payment providers. For example, this might include encouraging or brokering voluntary interoperability amongst players for whom it would be commercially beneficial. Additionally, encouraging technologies that allow account portability across networks would help to reduce switching costs. The Central Bank of Kenya has promptly taken this problem into account, and has stated in the National Payment System Regulations, 2014, that “A payment service provider shall use systems capable of becoming interoperable with other payment systems in the country and internationally” and that “A payment service provider may enter into interoperable arrangements.” It is recommended that the GoK assess whether mandatory interoperability could be a desirable and viable option in future given that the incentives for voluntary interoperability are very unlikely to exist in Kenya given the current market structure.

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95 There is extensive literature on the potential bottlenecks created by exclusive contracts in two-sided markets. See, for instance, Armstrong and Wright (2007) and Evans (2013).

• Eliminate exclusive contracts between mobile payment providers and agents. The CAK, during consultations with the CBK, advised the draftees of National Payment System Regulations to modify the exclusivity contracts clauses between mobile money service providers and merchants. The current Regulations read as follows: “A contract for the provision of retail cash services entered into between a payment service provider and an agent or a cash merchant shall not be exclusive”. The Regulations also provide that an agent or cash merchant may provide services to multiple payment service providers or institutions provided that the agent or cash merchant has separate contracts for the provision of such services with each payment service provider and provided further that the agent or cash merchant has the capacity to manage the transactions for the different institutions. In future amendments to the regulation it may be worth considering the merits of rephrasing the latter point (regarding conditionality on capacity) so that the single merchant is able to decide on the number of providers it can manage and so that homogenous rules apply for determining lack of capacity in case rules are needed to safeguard liquidity in the system.

• Based on the results of the forthcoming study launched by the CAK, assess options to facilitate third party access to the USSD channel or other technological access solutions such as “thin SIM” technology.

• Promote higher price transparency of the prices for mobile payment system services.

2.3 ELECTRICITY

Regulations in the electricity sector are more constrictive in Kenya than in other middle income countries. Figure 22 shows that Kenya’s PMR score in the electricity sector is significantly higher when compared to the OECD average, and behind only to Costa Rica, South Africa, Honduras and Mexico. In countries such as South Africa, the inability to establish a framework to allow for entry and additional investments in generation has resulted in power outages and high prices. Kenya’s high PMR score is a first indicator that product market regulation is restrictive of entry into the electricity market. The sector faces various challenges such as inadequate generation capacity, weak and constrained transmission and distribution networks, frequent and prolonged outages, high generation and transmission costs, and low access of households and businesses to reliable electricity supply.

Figure 22: PMR Score for the Electricity Sector
(Scale is 0–6, from least to most restrictive of competition)


97 See for instance: http://www.ft.com/cms/s/0/69aa4a9e-7f89-11e4-b4f5-00144feabdc0.html#axzz3OnoDgcDh
A review of the characteristics of the electricity industry shows that Kenya's high PMR score is due to the following:

- **Certain segments of the electricity industry remain highly concentrated.** This is partially due to the historical evolution of the industry, with the Kenya Power and Lighting Company (KPLC) holding a monopoly on all segments of the market until liberalization in the late 1990s. The Kenya Electricity Generating Company (KenGen) controls the vast majority of the market for electricity generation and KPLC carries out transmission and distribution, as well as all retailing activities. There is also a lack of effective ownership separation between certain segments of the industry with the government participating in both KPLC and KenGen. This market structure is reflected in Kenya's PMR score for this sub-indicator.

- **Currently, consumers lack the power to choose their electricity provider,** although this is provided for in current legislation: the 2014 Energy Bill's proposals for mandatory open access provisions and the ability for large customers to choose their supplier would help to ease this constraint once implemented.

- **In Kenya, as in most other countries in the region, there is no liberalized wholesale market for electricity** and no specific plan for gradual liberalization, although alternatives to introduce competition in wholesale markets and for large consumers have been assessed.

Looking at the upstream market (electricity generation), KenGen accounts for close to 70 percent of installed capacity. As of November 2014, 13 Independent Power Producers (IPP), private investors who generate power, share the remaining 30 percent.\(^98\)

Looking at the downstream market, KPLC is responsible for transmission in most regions, as well as distribution and retail supply of electrical energy to end users. Under a single-buyer system, KPLC purchases power in bulk from KenGen and the IPPs, through bilateral contracts or Power Purchase Agreements (PPAs) approved by the Electricity Regulatory Commission (ERC). Recently, a number of private companies have started to contribute to the electricity generation, supplying power to the KPLC grid. Mumias Sugar Company, for example, cogenerates electricity and supplies 26 MW to the national grid.

Transmission to areas not reached by the KPLC grid is carried out by KETRACO (Kenya Electricity Transmission Company Limited), incorporated in 2008 and 100 percent state owned. The company was established with the mandate of designing, constructing, operating, and maintaining new high voltage electricity transmission infrastructure to and from the backbone of the national transmission grid.\(^99\)

In line with Vision 2030, KETRACO was set up with the objective of improving the quality and reliability of electricity supply in Kenya, widening the scope of transmission by supplying those areas currently left out by the national transmission grid, and reducing transmission losses and costs of electricity to final consumers.

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\(^99\) KETRACO website, available at [http://www.ketraco.co.ke/about/index.html](http://www.ketraco.co.ke/about/index.html)

\(^100\) State owned enterprises are highlighted in orange. In particular, the GoK holds 50.1 percent of KPLC’s shares, 70 percent of KenGen’s, and 100 percent of KETRACO’s.
Kenya’s Vision 2030 acknowledged the importance of creating a reliable energy market. The Vision has identified this sector as one of the infrastructural enablers for the long-term development strategy of the country. Electricity is a prime input for other sectors in the economy: ensuring an adequate supply of clean and affordable energy is considered a crucial step towards economic growth and development. The current regulatory framework is likely to maintain the high electricity costs for both residential consumers as well as enterprises. Local stakeholders complained that the cost of energy in Kenya is higher than in neighboring countries. Moreover, the 2013 Enterprise Survey on Barriers to Trade identifies electricity as a major input cost, limiting the ability of enterprises to do business (Figure 24).

As a first step, it is advisable to tackle the bottleneck characterizing the upstream market, where KenGen holds approximately 70 percent of market share in terms of installed capacity; the government has already taken steps in that direction. The Ministry of Energy and Petroleum has proposed the installation of 5,000 MW of power generation capacity, to be achieved by 2016. Bids for selecting private investors to develop various pre-identified projects are currently underway. The investors winning the bids will bear the costs of building the generation infrastructure and will subsequently sell electricity to KPLC, which is in charge of distribution and retail. This system is expected to open up the generation market to private investors and decrease the cost of electricity by 40 percent on average. Introducing projects of this kind is fundamental to reduce concentration in electricity generation and move forward towards an open market. A drawback to this instrument that allows for competition for the market is that KenGen is a member of the Sector Planning Committee, which identifies the generation projects that will be tendered, and has also participated as bidder in the tenders. In general, technology neutral tenders favor competition and efficiency compared to a central planning approach with defined locations, technology, and size of projects. KenGen participates in the committee that sets the rules and determines how the selection of investors will be done where KenGen is not a bidder for the project. Furthermore, it

Figure 24: Barriers to Carrying out Business in Kenya (average of six sectors)  

With a low percentage of electricity penetration, full liberalization in the retail market might not be a viable option in the short run. In Kenya only a small percentage (19.2 percent in 2011) of the population has access to electricity. Nevertheless, to succeed in creating a reliable energy market, accessible by the vast majority of Kenyans as envisioned by the Kenya 2030 Strategy, it is important to start tackling the regulatory concerns that characterize this market and establish a path to progressively liberalize the market and mitigate negative effects on market participants.

Source: Lear elaboration on 2013 Enterprise Survey.

(1) (1) Food, (2) textile & garments, (3) chemical, plastic & rubber, (4) other manufacturing, (5) retail, (6) other services


(3) National Energy Policy, November 2013, draft


is important to ensure a transparent and clear selection process by an independent committee to ensure that the most efficient firms enter the market. Given the predictability of the pipeline of projects and the limited number of firms in the sector, the CAK can also play a role in detecting potential bid rigging practices in the allocation of those contracts. In addition, the government is promoting renewable energy generation projects (Box 8).

In the future, establishing a system based on open access or wheeling could facilitate entry in the upstream market, increase competitive pressure to encourage generators and KPLC to become more efficient, and allow for efficient choice by large electricity consumers. The system could be designed in such a way as to improve the efficiency of the subsidies scheme in electricity supply and compensate stranded costs. For example, the progressive introduction of bilateral contracting between eligible (large) customers and generators would be an option. Proposed provisions in the Energy Bill 2014, go some way towards addressing this issue to allow for some choice for large customers.

**BOX 8: RENEWABLE ENERGY– FEED-IN TARIFFS**

Developing a reliable system for energy production is one of the pillars of the Kenya Vision 2030. In particular, the 2030 strategy has put forward the importance of creating an efficient system for electricity generation from renewable resources. For example, the Vision has flagged the relevance of mobilizing private sector capital for generation of electricity from renewable energy.106

Kenya has followed international examples and introduced feed-in-tariff (FiT) schemes to support the development of renewable energy (small hydro, solar, wind, geothermal, biogas and biomass) and to support the country’s great need for electricity generation. Feed-in tariffs are mechanisms designed to speed up investment in renewable energy technologies by offering long-term contracts to renewable energy producers and tailoring these contracts to the costs of the generation technology. In Kenya, they were introduced in 2008.107

Feed-in-tariffs are granted on a first-come first-served basis but the Ministry of Energy and Petroleum is now exploring the introduction of an auction system to allocate these tariffs. The adoption of an auction system is expected to create more competitive conditions for entering the generation market.108 Without a market-based solution for FiT allocation, entry conditions are altered, with the least efficient players having equal probability of entry as the most efficient ones. A case of best practice comes from Europe, Brazil and China, where governments have slowly started to move away from FCFS allocation of FiT, promoting a more competitive process. The need for change has often been supported by stakeholders. In the UK, for example, stakeholders indicated that due to budget limitations, it was desirable to rapidly switch to a competitive-constraint allocation process.109 Even small countries like Rwanda use a competitive process to select renewable energy projects. In Peru and Brazil, the use of competitive selection processes has substantially reduced the FiT paid by consumers (24% in Peru in the first tender carried out in 2009).

Sources: Feed-in-Tariff (FiT) Policy Application and Implementation Guidelines (2012); World Future Council (2013)

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Moreover, to promote stronger competition in the upstream market in the medium term, it is advisable to evaluate the Power Purchase Agreements system. Currently, the system is based on purchases between KPLC and generators that are regulated under PPAs, which are approved by the regulator. Because of the risk that characterizes investments in the electricity market in Kenya, PPAs are usually granted for a period of approximately 15-25 years. While there may be some justification for granting long-term PPAs, their duration might in some cases be longer than necessary to ensure the recovery of the investment. Indeed, in other African countries, for example in Ghana, recent plans to finance IPPs have been made without considering the need to have long term PPAs (IFC, 2014).

**RECOMMENDATIONS FOR ELECTRICITY**

- **Ensure a level playing field by limiting KenGen participation in the design and implementation of the 5,000 MW program.** While it is desirable that programs like the 5,000 MW are conducted, so as to open up the market for electricity generation to private investors and tackling the electricity cost and availability problem, it is also important to ensure competitive neutrality. Furthermore, the selection process should be transparent to guarantee that only the most efficient investors enter the market. To this end, it is very important that the CAK monitors tender procedures, in order to prevent or detect bid rigging.

- **Evaluate the conditions of PPAs to ensure that competition is not unnecessarily restricted in the long-term.** The duration of PPAs could be reduced to the minimum length that guarantees investors recover their costs, and attain a normal return on their investments. Internationally, PPAs have a duration of between 8 to 30 years, with Peru and Chile having the shortest duration (8 to 15 years) (Maurer and Barroso, 2011). Reducing PPAs duration, while still safeguarding and promoting investments at the upstream level, allows competition to take place in the market when this is viable. On the contrary, by granting PPA contracts for a significant period of time, the current scheme might isolate investors from competition for too long. Moreover, it is recommended to progressively reduce the duration of the PPAs that are signed in the following years so as to create a smoother transition to a fully competitive market in the medium term. In view of the transition to a competitive wholesale market, it is also important to consider removing exclusivity clauses in the PPAs.

- **Review the assignment schemes for feed-in tariffs, currently granted on a first-come first-served (FCFS) basis.** From a competition point of view, assigning FiT on a first-come first-served basis has its drawbacks. This criterion favors generators that have the ability to be first in line, and not necessarily those with the best projects or greatest abilities. Hence, Some steps have been made in this direction, and recently the Ministry of Energy and Petroleum has requested proposals to conduct a study to assess auction mechanisms for FiT.

As mentioned at the beginning of this section, there are other regulatory restrictions that are typical of the Kenyan energy market and have been captured by the PMR indicator. Nevertheless, because of the limited available infrastructure and coverage, these restrictions have been identified as secondary in the short term. A list of these problems is presented hereunder for future reference.

- **The framework allowing consumers to directly purchase electricity from generators is not clear.** The current Energy Act 2006 provides for large consumers (above a certain threshold to be established by the Minister) to be able to purchase electricity from licensed companies, but this provision was never implemented. In particular, Section 43 of the Energy Act provides that “all contracts for
the sale of electrical energy, transmission or distribution services, between and among licensees, and between licensees and large retail consumers shall be submitted to the Commission for approval before execution."

- From this article, it is not clear whether large retailers have the option of purchasing electricity in bulk from generators. Furthermore, the current structure imposes that large buyers submit a request to the ERC before being able to switch between licensees. If the procedure is lengthy enough, this is likely to influence consumers’ willingness to switch. These regulations are likely to impact the business environment, de facto restraining large retail consumers’ ability to choose and to easily switch from one licensee to another. A step forward has been made in this regard. Indeed, the Energy Bill 2014, now provides for mandatory open access at the transmission level and defines the eligible customers that can choose their supplier. The approval of the new bill could allow some large consumers to choose their suppliers and therefore exert some competitive pressure in the market. It is worth noting that given the structure of the sector and the reliance on large customers for cross-subsidies, implementation has to be assessed carefully.

- The GoK sits on the boards of KPLC, KenGen and KETRACO. In particular, the GoK holds 50.1 percent of KPLC’s shares, 70 percent of KenGen’s, and 100 percent of KETRACO’s. The Grid Code specifies that “the objective of competitive neutrality policy is the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities. Government businesses should not enjoy any net competitive advantage simply as a result of their public sector ownership.” The Grid Code limits the ability of firms to exercise anticompetitive pressure in the market. Nevertheless, allowing the GoK to be major stakeholder and having representatives of the Ministry of Energy in their boards could alter the level playing field for market players. Reforms to enhance corporate governance in state corporations could play a role in increasing management independence.

- While there is full unbundling between KPLC and KenGen on paper, interviews with local stakeholders have confirmed that some limitations exist in practice. KPLC and KenGen were vertically integrated until 1997, when the functions of generation were split from transmission and distribution. KenGen became a separate entity responsible for public-funded power generation projects. The persistence of strong links between the sole retailer and the largest (by market power) generator would certainly have the potential of modifying the level playing field. Better corporate governance rules and increased transparency and accountability on the implementation of the regulatory framework can reduce this risk.

2.4 PROFESSIONAL SERVICES

The Kenyan economy has started to rely more heavily on professional services. Even though the value added of professional services on the economy is relatively low (3 percent of GDP in 2007), this sector is amongst the most dynamic, with business services growing at a rate of 8 percent per annum over the 2001-2007 period. Figure 25 shows that the number of workers in the

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110 The Kenya Electricity Grid code reads: “This [the 1997 split] resulted in the unbundling of the formerly vertically integrated Kenya Power and Lighting Company (KPLC) into two entities. One of the entities going by the old name of KPLC is now responsible for the transmission, distribution and supply function while the second entity called Kenya Electricity Generating Company (KenGen) took over all publicly owned generation assets and is responsible for generation in competition with Independent Power Producers (IPPs).”

111 See Dihel et al. 2010.

112 Ibid.
Unlocking Growth Potential in Kenya

The professional services market is relatively abundant in Kenya. In terms of per capita availability, the number of workers practicing these professions in Kenya is significantly higher when compared to countries in the same geographic region such as Uganda and Tanzania. While there are around 20 accountants and around 15 lawyers for every 100,000 inhabitants in Kenya, there are less than 5 accountants and advocates for every 100,000 inhabitants in Uganda, and less than 10 and 5 respectively, in Tanzania. The lower availability of accountants and lawyers in Tanzania and Uganda could be the result of restrictive entry and conduct regulation imposed on foreign providers.

The PMR methodology provides a preliminary understanding of the regulatory restrictions that are likely to harm competition in this market. The Professional Services PMR sub-indicator covers entry and conduct regulations in the legal, accounting, engineering, and architecture professions. Figure 26 shows that Kenya’s average PMR score for all professional services is higher than the average score for OECD countries and the LAC average.

Indicators for the four professional services are constructed as an average of two subcategories: entry regulation, and conduct regulation. Entry is considered more difficult in the following cases: (1) the higher the number of services

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**Figure 25: Number of Accountants and Lawyers per 100,000 Inhabitants**

![Chart showing the number of accountants and lawyers per 100,000 inhabitants in Uganda, Tanzania, and Kenya.](source)

**Figure 26: Average PMR Score for All Professional Services**

![Bar chart showing the average PMR score for professional services in various countries.](source)

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113 Ibid.
114 For example, Tanzania imposes stringent registration requirements on accountants that involve several government entities, and certified public accountants must be professionally qualified by both domestic and foreign bodies. To become an accountant in Uganda, applicants must have extensive experience and belong to an international accounting institute or association. Aspiring lawyers in Uganda must be citizens or residents and, if working abroad before applying, they must have been legal practitioners for at least five years in a country approved by the Law Council. If approved, they must work with a domestic counterpart or as a state attorney for at least six months and must have lived in Uganda for at least a year. World Bank (2014), pp. 20-21
115 BRICS average has not been calculated since data for India and Russia are unavailable for this indicator.
2. Sector-Specific Analysis of Product Market Regulations

the profession can provide under an exclusive or shared rights; (2) the higher the number of years of education, compulsory practice, and exams required to practice; (3) if membership in a professional organization is required; (4) if there are quotas on the number of foreign professionals/firms permitted to practice in the country.\textsuperscript{116} Conduct regulation is considered restrictive in the following cases: (1) if the fees charged by the profession are regulated by the government; (2) if there are restrictions on advertising and marketing activities; (3) if only some forms of business are permitted (e.g. sole proprietorships, limited liability partnerships, private companies, public limited companies); (4) if cooperation between professions is forbidden. Box 9 provides a detailed explanation on how these kind of regulations can restrict competition.

\begin{center}
\textbf{BOX 9: INTERNATIONAL BEST PRACTICES—EC REVIEW ON COMPETITION IN PROFESSIONAL SERVICES}
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In 2004, the European Commission (EC) analyzed the professional service market and identified five main categories of rules that are most likely to restrict competition:

1. Fixed prices – According to the EC, these instruments are likely to have the most detrimental effect on competition. They reduce the benefits that competitive markets deliver onto consumers, severely limiting consumers’ choice. In most Member States of the EU, fees are negotiated between the service provider and the client.

2. Recommended prices – This kind of practice has a negative effect on competition as it might facilitate coordination of prices between practitioners.

3. Advertising restrictions – Advertising facilitates competition, to the extent that it provides information to consumers and allows them to make better-informed decisions. Furthermore, the EC recognizes that comparative advertising can be a crucial competitive tool for new firms entering the market and for existing firms wanting to launch new products.

4. Entry restrictions and reserved rights – Excessive licensing regulation is likely to reduce the supply of service providers, with negative consequences for competition and quality of service. These can take the form of minimum periods of education, professional examinations, and minimum periods of professional experience. In many cases, entry restrictions are coupled with reserved rights to provide certain services. Entry restrictions, combined with reserved rights, ensure that only practitioners with appropriate qualifications and skills can carry out certain tasks.

5. Regulations governing business structure and multidisciplinary practices – Business structure regulations may have a negative economic impact if they prevent providers from developing new services or cost-efficient business models. For example, these regulations might prevent lawyers and accountants from providing integrated legal and accountancy advice for tax issues or prevent the development of one-stop shops for professional services in rural areas. These regulations can restrict the ownership structure of professional services companies, the scope for collaboration with other professions and, in some cases, the opening of branches, franchises or chains.

\textsuperscript{116} See annex 3 for further explanation on the calculation of the indicators.
Accounting profession

Kenya’s PMR score for the accounting profession is slightly higher than the OECD average and higher than the LAC average (Figure 27). Regarding entry into the profession, the main constraint is that a number of services are provided by the profession under an exclusive right. In terms of conduct, the principal restrictions come from marketing and advertising being restricted for service providers, and cooperation across sectors only being allowed between comparable licensed professions. In particular, considering advertising, while providing general information on the service provided is permitted, it is forbidden to provide specific information.\textsuperscript{117} For example, according to the Institute of Certified Public Accountants of Kenya (ICPAK) (2006), paid announcements in the press are permitted in the case of an opening of a new office, changes in membership, changes in the name/address of a firm, and appointment of a new member at the firm. ICPAK guidelines on marketing and publicity further clarify that “while marketing, which is the process of identifying client needs and making the product to satisfy these, is acceptable, advertising which is the communication to the public of the services that a professional accountant has to offer, is limited by law, custom and the Code of Ethics.”\textsuperscript{118} These restrictions therefore limit market strategies available to professionals.

Legal profession

In the legal profession, Kenya’s PMR score is considerably higher than the LAC average and higher than the average OECD score (Figure 28). In Kenya advocate fees are regulated: the Advocates Act provides that the Chief Justice may regulate remuneration of advocates in respect of all professional business. Specifically, the Advocates Remuneration Order prescribes the range of minimum fees to be charged for certain classes of work. Recently, the 2014 Advocates Remuneration Amendment Order 2014 has been gazetted, and the new order sets minimum fee levels for a wide range of legal work. The amendment raises fees across the board by around 40 per cent.\textsuperscript{119}

Figure 27: PMR Score for the Accountancy Profession
(Scale is 0–6, from least to most restrictive of competition)


\textsuperscript{117} Code of Ethics for Professional Accountants, Institute of Certified Public Accountants of Kenya (ICPAK).
\textsuperscript{118} Ethical Marketing and Publicity Practices In The Accounting Profession, Guideline 1/2010, ICPAK.
\textsuperscript{119} Legal notice No.35-1, available at: http://www.judiciary.go.ke/portal/assets/files/NEWS/Legal%20Notice%20No.%2035-1.pdf
There are restrictions for foreign practitioners and limits to the structure of businesses. Kenya does not allow foreigners to practice the law unless they work with a domestic counterpart, and independent firms associated with foreign partners are not allowed to use the branding of their international partners. Moreover, foreigners cannot file a plea in court (World Bank et al., 2014). Entry is further constrained by the fact that membership in a professional organization is compulsory in order to legally practice. Cooperation across the sector is only allowed between comparable licensed professions, and only some businesses are permitted (e.g. Limited Liability Partnerships and Sole Proprietorships).

Considering advertising, a step-forward was made on March 29, 2012, when the High Court of Kenya ruled that advocates could advertise their services. Judge David Majanja in the Matter between Okenyo Omwansa and Another vs. The Attorney General & two others (High Court petition No. 126 of 2011) declared that Rule 2 banning advertisements by advocates was unconstitutional and inconsistent with Article 46 (1) and 48 of the Kenya Constitution, 2010. To respond to this ruling, the Law Society of Kenya recently published the Advocates’ (Marketing and Advertising) Rules 2014. Advocates are subject to these rules when deciding to advertise their services. In particular, the regulation requires advertising to be “objective true and dignified”, and imposes limitations on the content, means, and manner of advertising. For instance, it lays down the information that can be advertised and the information that “may not be included”, such as names of clients, pictures, and reference to tariffs. Moreover, for each means of communication, specific limits are imposed regarding the size and also the frequency of advertising; for instance, a lawyer can place a magazine advertisement which should not exceed the size of 5 x 5 inches and can only do so once per quarter in each year. These advertising rules are still restrictive and do not allow advocates to make reference to the fee charged, identify former clients, nor mention any award obtained.\textsuperscript{120}

\textsuperscript{121} The establishment of the Board of Registration of Architects is provided by the Architects and Quantity Surveyors Act, section 4 – the Board consists of eight members who shall be architects or quantity surveyors and of whom—(a) four, at least one of whom shall be a quantity surveyor, shall be nominated by the Minister, and (b) four, at least one of whom shall be a quantity surveyor, shall be nominated by the Architectural Association of Kenya and approved by the Minister.
Engineering profession

Considering the engineering profession, Kenya’s score is slightly higher than the OECD average score but falls below the LAC average (Figure 29). Entry into the profession involves basic requirements such as a mandatory exam to practice the profession, in addition to compulsory university education (five years on average), and licensing. Engineers also enjoy exclusivity rights, in some cases together with architects, for some activities such as the preparation of feasibility studies, planning, designing, drawing, construction, commissioning, operation, maintenance, supply of specialized engineering equipment, and management of engineering works or projects. Conduct is not strictly regulated, with the only constraint being that cooperation is allowed only between comparable licensed professionals.

A step forward has been made regarding restrictions on foreigners. Article 6 of the Engineers Board of Kenya Draft Regulations, issued by the Ministry of Transport and Infrastructure in October 2014, grants foreign persons the possibility of being eligible for registration as a temporary engineer provided they make an application to the Board in the prescribed form upon payment of the prescribed fees; provide proof of valid practicing license from the country of domicile and previous engineering services done and completed in the past five years; provide an undertaking that the person shall transfer technical skills not available locally to Kenyan engineers as the Board may determine. Furthermore, registrations are renewable every one calendar year and are valid for the entire duration of the contract of the project.

Architecture profession

Kenya’s PMR score for the architecture profession is significantly higher when compared to the OECD and LAC average scores (Figure 30). Regulation of entry is very strict, with regulation requiring one year of practice and successful completion of a professional exam to become a full member of the profession. Furthermore, becoming an architect in Kenya requires having at least one year of domestic experience or demonstrating sufficient knowledge of the country’s building contract procedures (World Bank et al., 2014). In addition, a relatively high number of services (four) are provided by the profession under an exclusive or shared right. Cooperation is only allowed between comparable licensed professionals. Regarding conduct, minimum prices charged are regulated.
by the Board of Registration of Architects. The Architects and Quantity Surveyors Act reads as follows: “[on remuneration] Architects in Kenya are required to uphold and apply the scale of professional charges published by the Board of Registration of Architects and Quantity Surveyors.”

RECOMMENDATIONS FOR PROFESSIONAL SERVICES

- Effectively introduce mechanisms to allow foreigners to provide specialized professional services. Imposing restrictions on foreigners is equivalent to lack of compliance with the EAC Common Market Protocol, which requires professional service suppliers and providers from across the region to be guaranteed equivalent treatment with respect to local providers. The draft regulations for engineering that consider temporal permits for foreigners are a step towards facilitating entry to the sector. Ensuring compliance with the EAC Comment Market Protocol in this area can also help to enhance cooperation in the regulation of professional services at the regional level and thus encourage implementation of reform of advertising restrictions and minimum pricing provisions.

- Eliminate minimum prices for professional services, particularly legal and architecture services. Minimum price limitations are often justified by the need to maintain certain quality standards in the provision of the services that would be impaired with extremely vigorous price competition. Nevertheless, the impacts of such price regulations should be carefully evaluated because the result is likely to be higher prices for consumers or unserved demand without necessarily ensuring quality services. As an alternative, it could be worth considering increasing transparency on service standards or increasing the information conveyed to consumers on quality as a less restrictive, and potentially more effective, means of achieving the goal of quality assurance.

- Eliminate any further constraints on advertising. Advertising allows consumers to make well-informed choices. Currently, across professional services, it is prohibited to make reference to any former client. Allowing professionals to advertise their client range, as long as it is based on verifiable and representative information, would boost competition. This would, in fact, be a signal

Figure 30: PMR Score for the Architecture Profession
(Scale is 0–6, from least to most restrictive of competition)
through which professionals could distinguish themselves and their services. Based on the High Court of Kenya ruling that advocates can advertise their services, other professions could also eliminate provisions on advertising. The CAK could play a role in disseminating information about the existence of such rulings and advocating for reform.

- **Allow partnerships across professional services.** Currently in Kenya, cooperation across professions is forbidden for a number of professional services. As mentioned in Box 9 above, these restrictions are likely to prevent the exploitation of synergies that exist across professions. Moreover, they are likely to restrain the expansion of one-stop shops for professional services in rural areas, which would be useful in a country with the geography of Kenya.

### 2.5 INSURANCE

Although there are a number of insurance companies operating in the industry in Kenya, the current regulatory framework does not create incentives for firms to compete. In Kenya, there are 49 insurance companies and three re-insurance companies. The regulatory body which provides oversight to the market is the Insurance Regulatory Authority (IRA), established in 2007 with the mandate of regulating, supervising and developing the insurance sector in Kenya. Its objectives to maintain a fair, safe, and stable insurance sector, to protect the interest of the insurance policyholders and beneficiaries, and to promote the development of the insurance sector, have been pursued through instruments that limit the incentives of firms to innovate, expand their product offering, and offer better insurance conditions.

The **Insurance Act contains some provisions that limit the level of competition in this market.** The relevant statute for insurance matters is the Insurance Act, the provisions of which are currently under review with the development of a Draft Insurance Bill 2014. The Draft Bill marks a shift from the compliance-based provisions of the Insurance Act to a principles-based and risk-based regulatory framework. Some of the provisions of the Act which are restrictive of competition have been addressed in the Draft Insurance Bill 2014 while others remain. In the following few paragraphs, the main regulatory issues will be presented.

**Foreign equity participation in an insurance company has a ceiling of 66.7 percent and this could affect the prospects on entry and expansion of insurance companies.** In principle, domestic ownership needs to be encouraged so far as possible but domination of domestic ownership generally leads to deep stagnation in developing best industry practices. Ultimately the value of having a solid and professional insurance sector well exceeds the effects of having foreign-owned insurers take stakes in the market. Setting restrictions on foreign participation in insurance and brokerage is likely to restrain competition by altering entry conditions. Moreover, liberalizing ownership controls would allow insurance companies to have access to additional sources of capital, which is always welcomed in this sector. This has been taken into account by the IRA and the latest version of the 2014 Draft Insurance Bill allows a subsidiary of a foreign insurer to be granted a license, provided that “the Authority will be able to obtain adequate information concerning the holding company and other members of the group”. Once the law is amended, specific rules need to be issued to establish information requirements and criteria for licensing in order to increase predictability.

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124 Specifically, Section 22 of the Insurance Act reads: 

* [...] no person shall be registered as an insurer under this Act unless that person is a body corporate incorporated under the Companies Act (Cap. 486) and at least one-third of the controlling interest, whether in terms of shares, paid up share capital or voting rights, as the case may be, are held by citizens of Kenya or by partnership whose partners are all citizens of Kenya or by a corporate body whose shares are wholly owned by citizens of Kenya or is wholly owned by the Government.

125 Section 20(g), Insurance Act 2014.
Furthermore, the Insurance Act provides that every time an insurance company sets premiums these have to be approved by the regulatory body, restricting competition on prices. Section 75 of the Insurance Act clearly states that “an insurer carrying on general insurance business shall file with the Commissioner a schedule or manual of rates of premium proposed to be used by the insurer for each class of business”. Section 75 also provides that, in the case of revision of said premium rates, the insurer has to file with the Commissioner “the details of and the reasons for, at least sixty days before giving effect to the alterations or revision”. If an insurance company is found “charging a rate of premium other than that filed with the Commissioner under section 75”, under section 67(D) of the Insurance Act, it is “liable to pay a penalty of two hundred thousand shillings”. These regulations diminish the ability of market players to compete on the basis of price and de facto set minimum prices for insurance services. The IRA, on the basis of historical data, defines a band within which prices for the specific services shall fall. Brokerage fees are subject to similar restrictions, and, according to the Act, “no insurer shall pay to a broker or agent as brokerage commission, any sum in excess of the amounts prescribed for or in respect of each prescribed class of business placed by that broker or agent with that insurer.” These kinds of provisions limit the business strategies available to market players, who are unable to differentiate themselves on the basis of prices, or a combination of lower prices and additional services. Moreover, OECD (1998) stresses that, in some cases, price controls can act as a ceiling (rather than a floor) on premiums. As a result, in these cases, insurance companies are likely to decrease the extent of coverage.

Unlike Kenya, in a fully liberalized insurance market, market players have a more important role under close monitoring of the regulator. The market itself determines: (a) which insurance companies remain in the market; (b) what and how products should be sold; and (c) the premiums at which products should be sold. However, regulatory supervision still has an important role to play even in a fully liberalized insurance sector. Every insurance company set its own premiums according to the risk of policyholders: companies price the risk using an actuarial approach and provide risk transformation and pooling services. The better a country's insurance system (including its approach to assessing risk and determining premia, as well as the supervision model which supports this system) is at providing these various risk management services, the greater the saving and investment stimulation that can be achieved.

Experiences from various countries show the gains that can be made from removing direct price controls on insurance premiums. Experience in OECD countries has shown that removing regulations on insurance prices typically expands coverage, to the benefit of consumers (OECD, 1998). The history of insurance pricing in EU countries shows that, while in the short run premiums generally rise, in the long run liberalization leads to a progressive decline in the cost of insurance. In France and Italy, for example, as a consequence of deregulation, companies that have been able to tailor premium rates to individuals have enjoyed better profitability (Gönülal, 2009). Oetzel and Banerjee (2008) find that the performance of insurance firms in emerging markets improves with gradual deregulation. Vittas (2003) examines the benefits to the insurance market in Mauritius from operating in an environment of sound regulation, without premium, product, investment and reinsurance controls, while Gönülal et al (2012) discuss the benefits to consumers of the entry of new Bancassurance products in developing countries. Regarding market structure, Outreville (1996) tested the impact of monopolistic insurance markets on market development in developing countries and found a negative and significant effect. Gönülal (2009) also stresses how, for the liberalization process to be successful, the following issues should be considered: (i) defining a proper time frame; (ii) identifying
In line with international experience, the latest version of the 2014 Draft Insurance Bill does not require premiums to be IRA-approved. Nevertheless, Sections 59 to 62 mandate insurance companies to appoint an actuary, in charge, amongst other duties, of reporting information that suggests that the business of the licensed insurer is not, or likely at any time in the next three years, to be in a financially sound condition. The 2014 Draft Insurance Bill thus removes part of the administrative constraints imposed on insurance companies. As just described, this Draft Bill grants the IRA the ability to impose remedies in case an insurance company is judged (soon) to be insolvent. While some regulation is desirable to safeguard the interests of consumers, the implementation of those provisions should allow for enough flexibility to set premiums and define product characteristics without restraining insurers’ strategies, and hence competition. Furthermore, guidelines would be necessary to ensure that actuaries are not channels for coordinating pricing strategies among market players.

However, in Kenya—like in many low and middle income countries—actuarial capabilities and data availability are challenges for designing insurance products that can help companies compete effectively. Better insurance products could be designed if companies had access to more detailed and systematic data that can help them to calculate more accurately the actuarial risk and to design products targeted at policyholders with different risk profiles. Every effort needs to be made to enable better training in this field. Usually insurance companies neither have real data capabilities nor the right level of awareness as to what they could achieve if they had the right data. The regulator could play a role steering the sector towards a scenario with an improved level of data capabilities. In addition, the regulator needs to be able to collect data for all insurers on a comparable basis.

From the consumer perspective, access to sufficient information on the insurance policy and assurance that insurance claims will be properly managed by all insurers is essential to allow them choose their best deal, stirring competition. Policyholders should be able to choose a good and suitable product to protect their own interest and have the assurance that they can receive the agreed coverage in a timely manner. The variability of typical insurer responses to claims is high. Therefore, there is a strong case in many developing markets for some centrally monitored frameworks to ensure that insurance claims get a reasonably similar treatment from one insurer to another. Otherwise it becomes impossible for the consumer to know the value of the product that is being offered.

RECOMMENDATIONS FOR INSURANCE

- Progressively reduce restrictions on foreign ownership by eliminating limitations on foreign equity participation in the insurance sector, including brokerage services, as proposed in the Draft Insurance Bill 2014.
- Review the function of the regulator as it concerns its involvement in premium setting and brokerage fees, to ultimately remove any undue administrative constraint on insurance companies. Indeed, the role of the regulator should be that of ensuring that companies are solvent and not to control premiums charged. Encouraging companies to compete on prices would boost competition in the industry, to the benefit of consumers. Furthermore, information sharing agreements between insurance companies on market risks should not be restricted, in so far as the
activity is beneficial to the development of the market (OECD, 1998). When administrative constraints on setting premiums are removed, it is important to establish prudential regulation in order to prevent the sector from becoming vulnerable. Finally, supporting the IRA in implementing its proposed risk based capital framework should assist in better aligning the capital required by firms with the risk they face.

- **Monitor the industry to prevent collusive behavior.** A potential drawback of deregulating the insurance market is that market players may be tempted to avoid a price war by explicitly or implicitly colluding on prices. The peculiar features of the insurance market, where companies necessarily share information to be able to effectively evaluate risk, may facilitate sharing of other pieces of information (i.e., information on prices or other commercial conditions). It follows that when companies are free to price their products, the most convenient solution is to substitute regulated prices with a tacit or explicit collusive behavior. Colluding on premiums would create higher profits for all companies. This kind of behavior has strong repercussions on welfare, with final consumers facing higher prices, but not greater quality of services. Final consumers will only be able to enjoy the benefits of the competition that arises when premium setting regulation is loosened, when collusion is strictly monitored by the Competition Authority, and when the industry is disciplined. For this reason, it is highly recommended that the CAK monitors this industry and exerts its enforcement powers so as to be able to punish collusive behavior or the adoption of practices that facilitate tacit or explicit collusion. To this end, promoting cooperation between the CAK and IRA is desirable.

- **Ensure policyholders have access to sufficient information and set up efficient claims management.** There is a strong case in many developing markets for some centrally monitored frameworks to ensure a standard process for managing claims. A proper complaints process (for example an “Ombudsman” office) as well as a central discipline on court procedure is also desirable to make insurers behave properly when handling claims.

- **Enhance prudential competition and market-conduct regulation and supervision while the industry moves towards liberalization.** Insurance regulatory and supervisory bodies in many developing countries and emerging markets are not sufficiently attuned to protecting policyholders in a liberalized and more competitive market. The movement from a restrictive to a competitive insurance market does not take place overnight. For this reason, it is highly recommended that complementarities between prudential supervision and market conduct supervision are harnessed in implementing IRA’s planned move towards a risk-based pro-competitive insurance regulations, in a way that at the same time provides adequate protection to the policyholders.

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126 According to Fiscalia Nacional Economica (2011), examples of relevant information that shall not be shared are: information on pricing policies (current or future), cost structures, production volumes (current or projected), expansion plans and investments, import policies, market shares of the members of an industry or sector, customer lists, discount policy, terms and conditions of payment, business strategies, and techniques for the design and content of bids or proposals for future tenders. Further, Fiscalia Nacional Economica recommends to (i) share historical information only; (ii) share information in an aggregate form only; (iii) outsource information processing and collecting.

127 For example, by raising awareness among consumers and incentivize them to report complaints.

128 For example, by strengthening the number and quality of information shared between the IRA and the CAK and conducting joint market inquiries, among others.
2.6 AIR TRANSPORT

Market regulations in the air transport sector in Kenya are in line with those of OECD countries. The air transport PMR score for Kenya is only slightly higher than the OECD average. Kenya has an open skies agreement with the United States and participates in regional agreements in East Africa, although they have not been fully implemented yet. Furthermore, there are no restrictions on the number of domestic airlines that are allowed to operate domestic routes or controls on airfares. In addition, in 2006 Fly540, a Kenya-based, low-cost airline was established, representing the first Low Cost Carrier (LCC) model in the East African region. A recent study by Schlumberger and Weisskopf (2014) on the development of LCCs in the EAC finds that prior to Fly540’s entry, Kenya’s domestic market appears to have been clearly divided between the more prominent domestic routes (for example, Nairobi to Mombasa or Eldoret) served by Kenya Airways, and the thinner routes by local carrier Air Kenya Express. This division occurred in recent years with the exit of domestic carriers, such as JetLink Express (which ceased operations in 2012) and African Express Airways from some these routes. The study also finds some evidence that the entry of the LCC has been driving down fares in Kenya’s domestic market. On the routes where LCC Fly540 is present in Kenya, Kenya Airways offered lower fares by a small margin. Nevertheless, despite the entry of competitors in some key routes, evidence suggests that there is further scope to improve the competitiveness of the sector. Schlumberger and Weisskopf (2014) find that many routes in Kenya’s domestic market are still served only by Kenya Airways. On an international intra-East African Community (EAC) level, an analysis of the top intra-EAC routes in 2013 showed that those routes to or from Nairobi (NBO) appear to be the most concentrated. Even on routes where more than two carriers operate, such as the Nairobi to Entebbe route or the Nairobi to Dar es Salaam route, these routes are mostly dominated by one carrier. The study also provides a comparison of fare levels in the EAC market against comparable routes in other regions that are currently operated by LCCs. They find that Nairobi (NBO) and Dar es Salaam (DAR), for example, is over 100 percent more expensive than the route between Kuala Lumpur (KUL) and Phnom Penh (PNH). The fare from Nairobi (NBO) to Zanzibar (ZNZ) is almost three times higher than from Chennai (MAA) to Colombo (CMB). Whilst in some cases taxation and charges account for a large proportion of this difference, there are also some cases where the base fare is much higher than comparators which could be directly linked to limited competition (Schlumberger and Weisskopf (2014)).

Further analysis has brought to light two characteristics of the air transport market which may hinder competition. First of all, in Kenya, there are ownership restrictions on foreign investors. According to the Civil Aviation (Aircraft Registration and Marking) Regulations, 2007, “The following persons shall be qualified to be the owners of a legal or beneficial interest in an aircraft registered in Kenya, or a share therein—

a. the Government of Kenya;
b. a citizen of Kenya or a person bona fide resident in Kenya;
c. such other person as the Authority may approve, on condition that the aircraft is not used for commercial air transport, flying training or aerial work and such other conditions as the Authority may specify;
d. a body corporate- (i) established under the laws of Kenya; or (ii) established under and subject to the laws of such country as the Authority may approve. There might be limits on shares of domestic airlines owned by foreigners.”

Foreign ownership of airlines is limited to 49 percent in Kenya. Limiting the ability of foreign entrepreneurs to enter the domestic air transport market can severely restrain competition. Restrictions on foreign ownership have been supported on the grounds of national security concerns and the fear that foreign airlines taking over domestic airlines might discontinue servicing less profitable routes. These restrictions are likely to alter entry conditions in the market, effectively precluding foreign investors from participating in the market; this has reportedly affected investments of a foreign company in the sector. Furthermore, liberalizing ownership controls would allow domestic airlines to have access to additional sources of capital, reduce debt, and reduce the average cost of capital. An alternative to liberalized ownership is to grant a right of establishment, allowing foreign investors to set up alternative air carriers. This could boost competition, increasing consumer choice and promoting lower fares.

Second, Kenya lacks a well-defined coordination mechanism for take-off and landing slots. Whilst stakeholders do not consider Jomo Kenyatta International Airport (JKIA) (NBO) to be congested, the Kenya Airport Authority (KAA) estimated that NBO has been operating above its capacity for some years, receiving more than five million passengers in 2008, while having a capacity of 2.5 million. Moreover, Schlumberger and Weisskopf (2014) find that when assuming a ten-minute time lag between each flight, NBO has already exceeded its runway capacity. Although this situation may be partially dealt with through the current airport expansion, slot allocation may become an issue in the future as traffic increases, affecting the competitive conditions in air transportation markets. Currently slot coordination activities are managed by the Ground Flight Safety Section of the Kenya Airports Authority (KAA), with slots being allocated on a first-come first-served basis. Furthermore, in Kenya, there is no secondary market for slots assignation. In the context of congestion, the current slot allocation system would favor the incumbent, thus allocation rules will become increasingly important for Kenya as congestion at NBO increases.

The air transportation market is highly dependent on other airport services, including take-off and landing slots. To avoid distorting competition in the air transport market, it is necessary to ensure that there are no regulatory constraints in the allocation of slots. Box 10 investigates in greater detail the reasoning behind the importance of competitively assigning slots, presenting the European Union case-study.

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129 This is a highly debated subject. The Government of Canada, for example, suggests that these claims have no economic support (Government of Canada, 2008).

The European Commission on mobility and transport

<table>
<thead>
<tr>
<th>BOX 10: THE EUROPEAN UNION ON SLOTS ALLOCATION</th>
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<tbody>
<tr>
<td>The EC has recently acknowledged the necessity of modifying the current airport slots allocation policy. An analysis carried out between 2010 and 2011 showed that the current slot regulation system prevents optimal usage of the scarce capacity of airports. In 2011, the Commission presented the Airport Package, proposing to change the current regulation and allow for a market-based mechanism for slots distribution. The package also calls for greater independence of the slot coordinator and for allowing airlines to trade slots in a transparent manner. Currently, when an airport expands, coordinators distribute the additional take-off and landing slots, saving 50 percent for new entrants, while the remaining 50 percent goes to incumbents on a first-come first-served basis.</td>
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<tr>
<td>Specifically, the Airport Package proposal on airport slots allocation (December 1st, 2011) foresees:</td>
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<tr>
<td>1. Allowing airlines to trade slots with each other at airports anywhere in the EU in a transparent way;</td>
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<tr>
<td>2. Reforming the rules designed to help new entrants access the market at congested airports. This will allow a greater number of carriers to challenge more effectively the ‘dominant’ carriers which have a large presence at busy airports;</td>
</tr>
<tr>
<td>3. Tightening the rules requiring airlines to demonstrate that they have used their slots sufficiently during the season;</td>
</tr>
<tr>
<td>4. Tightening the rules on the independence of the coordinator and increasing the level of transparency on slots transactions, in order to make the market work better.</td>
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</table>
| According to the research carried out by the EC, these changes would be worth €5 billion to the European economy. Negotiations on the adoption of this package are under discussion.  
Sources: The European Commission on mobility and transport (http://ec.europa.eu/transport/modes/air/airports/slots_en.htm); Clark (2011) |

The conditions on bilateral air transport service agreements affect competition in international routes. In recent months, bilateral agreements with Tanzania and Rwanda have been renegotiated, allowing for entry of Rwandan and Tanzanian carriers in the main routes from Nairobi to Uganda and Tanzania, respectively. However, Schlumberger and Weisskopf (2014) note that currently the existing bilateral regime between EAC states is more restrictive than that established by the Yamoussoukro Decision framework. In the bilateral Air Service Agreements (ASAs) between Kenya and Tanzania, for example, there are limits on frequencies, the destinations to be served in both countries are delineated, and there are no provisions for fifth freedom traffic. The implementation of the EAC Common Market Protocol commitments on air transportation could replace the current EAC system based on bilateral agreements with dissimilar conditions between partner states. This would allow for increased competition on a level playing field among airlines in the region, benefiting consumers.

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131 At present, negotiations are in limbo between the member states because Spain and the UK cannot agree on whether the new laws should apply to Gibraltar. See the European Regions Airline Association, available at http://www.eraa.org/policy/overview-and-news/eu-aviation-policy-2014
2. Sector-Specific Analysis of Product Market Regulations

**RECOMMENDATIONS FOR AIR TRANSPORT**

- Foster the implementation of the EAC Common Market Protocol regarding air transport liberalization in order to allow Kenyan consumers to benefit from competition in regional routes. This may also help to enhance cooperation in the regulation of air transport at the regional level and thus encourage implementation of the reform of restrictions on foreign ownership outlined below.

- Evaluate eliminating restrictions on foreign ownership for domestic and international air transport or, alternatively, grant foreign investors the right of establishment.

- Consider reforming current slot allocation procedures if NBO were to be classified as a congested airport. Given the importance of slots for the operation of airline services, slot allocation regimes should contribute to the creation of a level-playing field. OECD (2014) recommends that slot allocation should be guided by principles of neutrality, transparency, and non-discrimination to ensure the most efficient use of slots by airlines. To this end, the first step shall be to build on the coordination activities currently being undertaken by KCAA to establish a fully-fledged, independent slot coordinator. Slot coordination activities are usually undertaken by airport coordinators, in charge of efficiently managing the airport facility. The governance of airport coordinators is often very different from country to country. In general, it is recommend not to involve airlines in the management of slot coordination activities, as this will reduce the probability of collusion in the market. All in all, the market would benefit if the KCAA and the CAK work together to ensure the independence of these coordinators.

**Summary of Kenya’s Performance in Sector-Specific PMR Indicators**

Figure 32 summarizes Kenya’s performance in terms of its PMR score for sectors where the PMR score is available. The diagram depicts the restrictiveness of Kenya’s regulations relative to: (i) the average of the top five performers; and (ii) the country with the highest (most restrictive) score.

![Figure 32: Summary of Kenya’s PMR Score across Sectors](image)

Recalling the Product Market Regulation scores analyzed in detail in Part I, Kenya has room for improvement along the three dimensions of the index: state control, barriers to entrepreneurship (entry and rivalry), and barriers to trade and investment. The preliminary indication of the existence of regulatory obstacles to competition was confirmed by the results of the sector specific analysis. Moreover, with the passing of the Statutory Instruments Act 2013, Kenya is currently faced with the opportunity to increase the efficiency of its regulatory policy and enhance the policy-making process to ensure a focus on implementing more effective regulation.

In particular, the following areas merit attention:

1. Government intervention and the role of SOEs: It is recommended that government intervention be focused on situations where the private sector is unable to operate to achieve public policy goals.

The findings of the analysis show that in Kenya, the government regularly intervenes in business affairs. For example, the GoK is a major stakeholder in the network sectors, with majority holding over the three main companies handling the electricity supply chain and participation in the largest firms operating telecommunications, air transportation and postal services. While there might be valid public service reasons for government involvement, competitive neutrality in markets with private participation should be guaranteed. Moreover, through price control regulations and influence on market prices, the government imposes price ceilings and/or price floors. These restrictions are typical in the professional services, where price floor regulations forbid advocates and architects to charge lower fees. On the one hand, price floor rules have been justified as a mechanism to guarantee quality standards; on the other hand, such policies have drawbacks including higher prices and unserved demand. A set-up where professionals are able to compete over the price dimension would be desirable. Furthermore, in the agriculture sector, government involvement in commercial activities significantly affects the maize, sugar, fertilizer, and seed markets. Correcting these regulatory policies and government intervention in markets would enable better functioning markets in Kenya, with spillover effects onto productivity and growth.

2. Obstacles to market entry and rivalry: Kenya would benefit from reviewing regulatory rules that are likely to create discriminatory conditions between market players and that limit their business strategy options.

Throughout different sectors, there are a number of impediments to business development that shape markets conditions. Generally speaking, excessive red tape, discretion in the implementation of administrative requirements, and rules that allow incumbents to influence entry have a strong negative impact on market entry. Kenya would benefit from improving its regulatory quality and streamlining rules and procedures that facilitate entry of new
Unlocking Growth Potential in Kenya

players in various sectors. Moreover, sector-specific regulatory obstacles are likely to alter the level playing field and influence market players by restricting their business strategies. In the telecom sector, for example, porting fees and a lengthy number portability process impose high switching costs on consumers. Consumers are therefore locked-in with incumbents, entry of new telecom operators is discouraged, and competition is distorted. Similarly, in the market for mobile payment systems, lack of effective interoperability between operators and exclusivity contracts between operators and merchants are likely to create negative incentives and restrain entry and competition. Other restrictions, typical of the professional services market, such as limitations on advertising and partnerships across professions, limit business strategy options. For example, advertising, which is forbidden or strongly limited for advocates and accountants in Kenya, is a strategic tool for guaranteeing a level playing field and promoting innovation of services. Similar restrictions are present in agriculture. For example, in the case of tea, burdensome regulations and consent from incumbent operators to license new tea factories make entry difficult. Therefore, rectifying these regulatory constraints would improve competition, benefit consumers, and spur long-term growth.

3. Barriers to trade and investment: It is recommended that rules on restriction of foreign ownership across sectors be reviewed and barriers to trade in the agriculture sector be reduced.

Restrictions on foreign ownership characterize different markets in Kenya, such as the insurance and air transport sectors, as well as professional services. On the one hand, limitations on foreign ownership are usually justified on the ground of national security concerns, an argument that has not yet found economic support. On the other hand, allowing foreign investors to participate in local markets would bring more capital and know-how, allowing companies to become more efficient from an operational point of view. This would, in the long-run, strengthen innovation and competition and have beneficial spillover effects onto consumers. In addition, barriers to trade raise particular concerns in the agriculture sector where tariff and non-tariff barriers have been put in place in the sugar and maize markets for example.

4. Integrating analysis of the regulatory impact on competition into the policy-making process. Ensuring that regulatory design takes account of competition principles will allow the government to progressively eliminate regulations that create barriers to competition and hinder economic growth. This objective could be significantly advanced with the operationalization of the Statutory Instruments Act 2013. The development of an institutional and procedural framework for the Statutory Instruments Act, including the allocation of responsibility to an appropriate body for oversight of the regulatory impact assessment process, would thus be a crucial step in integrating the analysis of regulatory impact on competition into the cost-benefit analysis of proposed policies, bills, and regulations. A successful regulatory impact assessment system requires a high level of coordination to align efforts at various levels of government, and across government ministries and independent regulators. Therefore, monitoring and oversight institutions can offer quality control by providing three services to officials undertaking assessments: (i) consultation and technical assistance in drafting the assessment; (ii) review of individual assessment; and (iii) stocktaking of general compliance with regulatory assessments by law makers (OECD, 2008).
Expected benefits from reforms

All in all, it is expected that improving the regulatory framework to allow firms to enter the market, expand their operations, and compete on their own merits, will improve productivity and lead to higher long-term growth.

Adopting regulations that are more conducive to competition in the electricity and professional services sectors is expected to increase annual GDP growth rate by at least 0.39 percentage points (equivalent to US$218 million in only one year). At least 15 economic sectors are highly dependent on either electricity or other services (proxy for professional services). Based on the empirical evidence from Barone and Cingano (2011), it can be estimated that a substantial reduction in the restrictiveness of regulations in these service sectors would increase the value added in the 15 economic sectors that utilize those services intensively (see Annex 5).

If all proposed reforms were to be adopted, the impact on the overall economy, in terms of total factor productivity growth, would be substantial and well above 1.3 percentage points. This report has highlighted a number of sector specific recommendations to strengthen the degree of competition in the Kenyan economy. Partial simulations run for Kenya show that even introducing sector reforms for the professional services only would result in a reduction of the overall sector-wide PMR score from 2.25 to 2.00. That is, if (i) minimum prices across professional services are substituted by non-binding recommendations on prices; (ii) regulations on advertising and marketing are lifted; and (iii) inter-professional cooperation is loosened, then the sector-wide PMR score for Kenya would drop by 10%. The literature suggests that this reduction would imply an increase in total factor productivity by at least 1.3 percentage points (IMF, WBG, OECD, 2014). Moreover, in terms of contributions to GDP, employment, and consumption, other sectors are more relevant to the Kenyan economy than professional services (Annex 3). Thus, it is reasonable to conclude that if all proposed reforms were to be adopted, the impact on the overall Kenyan economy, in terms of total factor productivity growth, would be even higher.

Various empirical studies conclude that higher competition has a positive effect on productivity growth. The empirical work of Aghion et al. (2008) shows that there is a positive effect of product market competition on productivity growth. They show that a 10 percent reduction in South African mark-ups would increase productivity growth by 2 to 2.5 percentage points per year. Moreover, using firm-level observations, Schiffbauer and Ospina (2010) find a positive and robust causal relationship between some defined proxies for competition and productivity. In particular, countries that reformed product market regulation during the period under analysis experienced a more pronounced increase in competition. The contribution to productivity growth due to competition spurred by these

<table>
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<tr>
<th>TABLE 5: EXPECTED IMPACT OF REFORMS ON GDP</th>
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<tr>
<td>Estimated impact on annual value added (percentage points)</td>
</tr>
<tr>
<td>Electricity</td>
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<tr>
<td>Professional services (2)</td>
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<tr>
<td>Total effect on value added (GDP at factor costs)</td>
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<tr>
<td>Total effect on GDP at market prices</td>
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</tbody>
</table>

Source: WBG

(2) Calculated based on other services excluding finance, water, and trade
reforms is measured to be around 12–15 percent. Wölfl et al. (2010) show how an improvement of half an index point, in terms of barriers to entrepreneurship, would translate into an approximately 0.4 percentage point increase in the average, annual rate of GDP per capita over the subsequent decade. Furthermore, IMF et al. (2014) indicate that a 10 percent reduction in the sector-wide PMR score of OECD countries translates into a 1.3 percentage point gain in total factor productivity growth over a time span of 10 years.

Experiences in other countries have also shown the positive effects of reforming product market regulations and, in particular, liberalizing trade and exposing domestic firms to foreign competition. Pavcnik’s study (2002) of Chile’s reforms in the 1970s and 1980s shows that the productivity of the producers that faced competition from imported goods improved, on average, by 3 to 10 percent more than the productivity of firms in sectors not subject to foreign competition. Therefore, in Kenya, the sectors that suffer from a production deficit and that are currently shielded from foreign competition would be those that would gain the most from trade liberalization.

Similarly, greater private participation in large, state-owned enterprises in sectors critical to the economy is likely to improve productivity. For instance, Cole et al. (2005) analyze the privatization of the Brazilian iron ore industry and show that productivity grew about 140 percent between the beginning and the completion of the privatization process (from 1990 to 1997), and output grew about 30 percent during this period. In Mexico, privatizations occurred during the 1983—91 period, and the authors found that output and productivity rose substantially following privatization, and in particular, mean sales increased by 54 percent. Furthermore, Cole et al. (2005) analyzed the privatization of the large vertically integrated “natural” monopolies (e.g., electricity, transport, and communications) in Argentina in the 1990s. In this case, they found that privatization led to cost reductions of 10 percent and production increases of 25 percent.

**The way forward**

For this reform process to run smoothly, the first step is advocacy to infuse competition principles in regulatory design. Having identified the sector-specific constraints, the government and the regulators, in coordination with the CAK, can modify rules and regulations with the objective of opening markets to competition. The guiding principle shall always be to compare alternative regulatory measures and choose that which is projected to have the least distortive impact on competition. Integrating the analysis of regulatory impact on competition into the cost-benefit analysis of proposed policies, bills, and regulations will be a useful action. The Statutory Instruments Act 2013, mandates regulatory authorities to prepare a regulatory impact statement for every statutory instrument (rule, order, regulation, form, by-law, resolution, etc.) that is likely to impose significant costs on the community. The required analysis includes the impact on the private sector and the effects on competition conditions. Furthermore, the Act mandates public consultations for all the instruments that are foreseen to affect competition. The implementation of the Statutory Instruments Act can therefore be used to prevent the adoption of new regulations that are likely to prevent competition.

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133 In the paper, Wölfl et al. compute the difference between the value of barriers to entrepreneurship of most OECD enhanced engagement countries (such as Brazil, Russia, India and South Africa) and the average OECD country, which roughly corresponds to 0.5 points in the PMR barriers to entrepreneurship score. GDP per capita is measured as GDP per working age population (15-64 years).

134 For this reason, it is highly recommended that the CAK engages with sector regulators and other government bodies to facilitate advocacy of competition.
Collaboration between sector regulators, subnational governments, and the Competition Authority of Kenya is essential to address existing regulatory restrictions to competition. According to the Competition Act No.12 of 2010, the CAK has a role in studying government policies, procedures, programs, legislation, and proposals for legislation so as to assess their effects on competition and consumer welfare, and also provide its opinion on them. Furthermore, the Competition Act acknowledges the need for the CAK’s collaboration with other regulators to ensure consistent application of the principles of the competition law. CAK has started to implement collaboration agreements with some regulators and to approach government institutions in sectors where competition enquiries have been launched or where anticompetitive practices seem to be prevalent. This advocacy work by the CAK could be strengthened through an inter-institutional platform. Guidelines prepared by the CAK for assessing the impact of regulations on competition can also be a useful instrument for national and subnational government entities interested in improving the quality of their regulatory framework.

The second step is for the CAK to exert its enforcement powers. When markets are opened and become subject to competitive pressure, anticompetitive behaviors, such as collusion or foreclosing strategies, are more likely to arise. The CAK should be proactive in monitoring the markets and consistently exert its enforcement powers in order to deter anticompetitive conduct. Collaboration with other government entities to monitor markets and flag out potential anticompetitive practices is also advisable.

Ideally, all reforms should be pursued at the same time, but given practical considerations, it is desirable to prioritize and begin with those reforms that are likely to have a greater impact on the overall economy. To define a priority order of sectors to reform, it is often useful to consider the following criteria, among others: (i) the sector’s relevance to the economy, in terms of added value and employment; (ii) the sector’s relevance for consumers; (iii) the sector’s relevance to other sectors; and (iv) those sectors characterized by a higher probability of success. Finally, to facilitate the political acceptance of reforms, it is desirable to persuade all stakeholders involved that sacrifice in the short-run is required from all actors (Box 11).

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BOX 11: COMPETITION AS A NEW SOCIAL CONTRACT

All market participants try to influence the regulatory environment so that their interests are promoted and protected. In doing so, they do not take into account the impact that some regulatory measures may have on other market participants and on the overall economy. This is the responsibility of political institutions that have to mediate among the various, and sometimes conflicting, interests of all actors. A possible equilibrium of this political process is one in which some groups of citizens are willing to accept the negative consequences of protecting the interests of others if they can benefit from the same form of protection of their own interests. Although this is a possible political solution, it is not the most efficient one. Moreover, economic interests that are dispersed, such as those of consumers, are not normally adequately represented in the political arena and they risk being neglected.

Establishing competition in the economy should be seen as a new social contract whereby all market participants accept to give up the measures that unduly shield their interests in exchange of similar reforms in other markets. Although each group of stakeholders may perceive this move as risky or unsafe, in the medium-run all will take advantage of lower prices, a wide variety of products, innovative services and, in general, a more dynamic and prosperous economic environment where new business opportunities can arise. It is therefore crucial that all sectors of the economy undergo such a transformation, so that competition is ensured in the economy as a whole, and across the board.
### Annex 1: Table of Recommendations

<table>
<thead>
<tr>
<th>Topic/sector</th>
<th>Subtopic/ subsector</th>
<th>Competition restrictions on</th>
<th>Recommendations</th>
<th>Implementing bodies</th>
</tr>
</thead>
<tbody>
<tr>
<td>State participation in markets</td>
<td>State-owned enterprises and price controls</td>
<td>X</td>
<td>• Review the economic outcomes of state participation in commercial activities (including impact on private sector development) and establish guidelines on when the GoK should engage in commercial activities or phase out</td>
<td>Ministry of Finance, sectoral ministries, Council of Governors</td>
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<td></td>
<td></td>
<td>X</td>
<td>• Approve a legal framework that defines the conditions under which county corporations might be established</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>• Review indirect price controls in agriculture through subsidies and influence of state-owned companies on prices</td>
<td></td>
</tr>
<tr>
<td>Licensing system</td>
<td>Regulatory quality and burdens on start-ups</td>
<td>X</td>
<td>• Continue the implementation of an overarching program across sectors and counties targeted at simplifying rules and procedures, as well as rationalizing licensing and permits systems.</td>
<td>Ministry of Industrialization and Enterprise Development, Council of Governors</td>
</tr>
<tr>
<td></td>
<td></td>
<td>X</td>
<td>• Reduce administrative burdens on start-ups including corporations and sole proprietor firms</td>
<td></td>
</tr>
<tr>
<td>Trade and treatment of foreigners</td>
<td>Barriers to trade in services and goods</td>
<td>X</td>
<td>• Reduce NTBs and resolve NTBs that obstruct the implementation of the EAC Common Market Protocol (to be implemented at national level with regulatory cooperation at the regional level)</td>
<td>Ministry of Foreign Affairs and International Trade, sectoral ministries, Public Procurement Oversight Authority</td>
</tr>
<tr>
<td></td>
<td></td>
<td>X</td>
<td>• Eliminate regulations that contain differential treatment of foreign suppliers in professional services and public procurement</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Evaluate the level of import tariffs for goods, particularly agriculture products</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• International / Regional Level Implementation</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Implement mutual recognition agreements in key sectors to facilitate trade, particularly in line with the EAC Common Market Protocol</td>
<td></td>
</tr>
<tr>
<td>Pro-competitive regulations</td>
<td>Advocacy</td>
<td>X</td>
<td>• Ensure operationalization of the Statutory Instruments Act 2013 through an appropriate institutional and procedural framework for the Act. Consider allocating oversight responsibility to an independent body</td>
<td>Parliament, Ministry of Industrialization and Enterprise Development, Ministry of Finance, Competition Authority of Kenya (CAK)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>X</td>
<td>• Implement mechanisms to integrate the analysis of regulatory impact on markets and competition in the design of policies and regulations based on the Statutory Instruments Act and the Competition Act</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>X</td>
<td>• Use market inquiries under the Competition Act to conduct periodic review of regulations in key sectors to achieve Vision 2030 and execute flagship projects</td>
<td></td>
</tr>
<tr>
<td>Topic/sector</td>
<td>Subtopic/subsector</td>
<td>Competition restrictions on</td>
<td>Recommendations</td>
<td>Implementing bodies</td>
</tr>
<tr>
<td>-------------</td>
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<td>----------------------------</td>
<td>----------------</td>
<td>------------------</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Entry</td>
<td>Level playing field</td>
<td>Business strategies</td>
</tr>
<tr>
<td>Agriculture</td>
<td>Staple Grains</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>Pyrethrum</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Tea</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>Sugar</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fertilizers</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Key areas to tackle restrictive, sector-specific product market regulations

- Reduce government involvement in markets through the NCPB, and maintain impetus in the reform of NCPB to separate its commercial functions
- Evaluate other market-oriented measures (commodity exchange platform, futures market, warehouse receipt system)
- Align import duties with commitments under regional agreements
- Create a regulatory environment, favorable to private sector development
- Ensure competitive neutrality of the PPCK (commercial activities formerly managed by the government)
- Ensure farmers have the option to switch between processors
- Review of the regulatory framework, including the Tea Act, the draft Tea Regulations and the draft National Tea Policy, to remove unnecessary requirements for factory licensing. Ensure proper implementation by the AFFA Tea Directorate
- Ensure that licensing decisions are market driven rather than determined by incumbents
- Review regulations which lock in growers with factories for an undetermined period of time
- Reduce trade barriers (import quotas, import permits and non-tariff barriers)
- Reduce government ownership to increase efficiency in the sector
- Remove reliance on the NCPB for subsidized fertilizer
- Evaluate mechanisms such as a voucher system, whereby farmers can procure fertilizer at a subsidized rate from various competing firms
<table>
<thead>
<tr>
<th>Topic/sector</th>
<th>Subtopic/ subsector</th>
<th>Competition restrictions on</th>
<th>Recommendations</th>
<th>Implementing bodies</th>
</tr>
</thead>
</table>
| Agriculture | Seeds               | X X X                        | • Increase openness and transparency of government tenders for licensing new seed varieties developed by government research institutions  
• Ensure competitive neutrality among private and seed companies with state participation  
• Consider the introduction of a voucher coupon system for maize seed supply as an alternative to subsidies through NCPB  
• Update the regulatory framework in the seed sector to facilitate private participation and increased production of quality seed | Ministry of Agriculture, Livestock and Fisheries; Kenya Plant Health Inspectorate Services; Kenya Agricultural Research Institute; CAK (reform advocate) |
|             | Artificial insemination | X X                          | • Ensure competitive neutrality between KAGRC and private producers of semen for artificial insemination  
• Separate KAGRC’s regulatory and commercial functions  
• Increase transparency on the quality standards for semen and reduce potential discretion in clearing imports  
• Publish legislation and guidelines to open up the space to private sector investment | Ministry of Agriculture, Livestock and Fisheries; CAK (reform advocate) |
| Electronic communications | Mobile Telecom | X X X X X | • Reassess the level of porting fees  
• Automate the procedure for number portability | Communications Authority of Kenya (CA) |
|             | Spectrum Allocation | X X X X X X | • Establish market-based rules to assign spectrum and prevent distortions in the competitive environment  
• Ensure the PPP framework for social and infrastructure projects does not distort the level playing field  
• Facilitate collaboration between CA and CAK to ensure competition in assigning mobile spectrum | Ministry of Communications Information Technology; Communications Authority of Kenya; CAK (reform advocate) |
|             | Mobile Payment System | X X X X X X | • Develop mechanisms to promote interoperability between operators  
• Ensure elimination of exclusive contracts between mobile payments providers and merchants  
• Assess options to facilitate third party access to USSD channels or SIM cards | CA; Central Bank of Kenya; CAK |
| Electricity | Generation | X X X X X X | • Ensure competitive neutrality between KenGen and other investors in generation  
• Guarantee a transparent selection process under the 5,000 MW program and monitor the process to prevent anticompetitive practices  
• Evaluate the conditions and length of PPAs to allow for competition in the medium-term  
• Pass and implement the Energy Bill 2014 to allow large customers to choose their supplier in the medium-term while mitigating effects on the current subsidy scheme across customer groups  
• Review the assignment method for feed-in-tariffs and promote market based solutions for FIT allocation | Ministry of Energy and Petroleum; Energy Regulatory Commission; CAK (reform advocate) |
<table>
<thead>
<tr>
<th>Topic/sector</th>
<th>Subtopic/ subsector</th>
<th>Competition restrictions on</th>
<th>Recommendations</th>
<th>Implementing bodies</th>
</tr>
</thead>
</table>
| Professional Services | Legal and architectural services in particular | Entry: X | • Minimize restriction on entry of foreigners in compliance with the EAC Common Market Protocol (to be implemented at the national level with regulatory cooperation at the regional level)  
• Eliminate minimum fees for professional services (legal and architecture services)  
• Eliminate constraints on advertising practices (all four services)  
• Allow partnerships between different service providers (all four services) | Law Society of Kenya; Ministry of Finance (accountants); Institute of Certified Public Accountants of Kenya; Ministry of Transport and Infrastructure (engineering); Engineers Board of Kenya; Ministry of Land, Housing & Urban Development (architects); Board of Registration of Architects; CAK (advocate) |
| Insurance | Insurance and brokerage services | Entry: X | • Remove any administrative constraints on premium setting and allow insurance companies to set their premiums independently  
• Effectively transform the regulatory approach from per product premium regulation to risk-based regulation based on solvency indicators  
• Remove limitations on foreign equity participation as established in the Insurance Bill 2014  
• Facilitate collaboration between CA and IRA to prevent anticompetitive practices | Insurance Regulatory Authority, Ministry of Finance, CAK |
| Air Transport | Passenger transportation | Entry: X | • Evaluate minimizing restrictions on foreign ownership  
• Establish a clear slot allocation procedure to increase predictability in case of congestion and ensure competitive neutrality  
• Regional Level Implementation  
• Support the implementation of the EAC Common Market Protocol to increase competition in regional air transport routes | Ministry of Transport and Infrastructure; Kenya Civil Aviation Authority, CAK (advocate) |
### Annex 2: State-Owned Enterprises by Sector

**Table 6: Presence of State Owned Enterprises in Selected Sectors Covered by PMR Methodology**

<table>
<thead>
<tr>
<th>National, state or provincial governments control at least one firm in the sector</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electricity generation, import, transmission, distribution and supply</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Natural gas generation, import, transmission, distribution and supply</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Telecommunication fixed line, mobile and internet services</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Post basic and courier services</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Railways transport</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Water transport</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Air transport</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Operation of air transportation infrastructure</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Operation of water transportation infrastructure</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Operation of road infrastructure</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Water collection, treatment and supply</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Manufacture of tobacco products</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Manufacture of refined petroleum products</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Manufacture of basic metals</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Manufacture of fabricated metal products, machinery and equipment</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Building and repairing of ships and boats</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Manufacture of railway and tramway locomotives and rolling stock</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Manufacture of aircraft and spacecraft</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Construction</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Wholesale trade, incl. of motor vehicles</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Retail trade, incl. of motor vehicles</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Accommodation, food and beverage service activities</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Other urban, suburban and interurban passenger transport</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Financial service activities, except central banking, insurance and pension funding</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Insurance, reinsurance and pension funding</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Other business activities</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Human health activities</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Motion picture distribution and projection</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Number of sectors</td>
<td>19</td>
<td>13</td>
</tr>
</tbody>
</table>

*Source: WBG 2013 Regulatory Questionnaire for Kenya that follows the OECD PMR Template*


2. Posta, established in terms of the Postal Corporation Act Cap 411, is controlled by the Government of Kenya.

3. KRC is a government parastatal that provides railways passenger/freight transportations services and owns the railways infrastructure by virtue of Section 19 of the Kenya Railways Corporation Act, Cap 397.

4. Government of Kenya is the biggest shareholder in Kenya Airways with 29.8% shareholding compared to other shareholders. See [http://mobile.theeastafrican.co.ke/News/-/433842/1422952/-/format/xhtml/-/79l2a2z/-/index.html](http://mobile.theeastafrican.co.ke/News/-/433842/1422952/-/format/xhtml/-/79l2a2z/-/index.html).
Annexes

1. Kenya Airports Authority is a government parastatal established under the Kenya Airports Authority Act, Cap 395.

2. Kenya National Shipping Line was established under the Companies Act in 1987, as a joint venture between Kenya Ports Authority and other strategic partners under UNCTAD Code for Liner Conferences to take advantage of business opportunities offered by the growing international sea-borne trade. Kenya Ferry Services is an autonomous company operated by Government of Kenya that provides ferry services across Likoni Channel and Mtongwe. See Kenya National Transport Policy http://www.krb.go.ke/images/company_doc_mot.pdf.

3. Kenya National Highways Authority was established under Section 3 of the Kenya Roads Act. Kenya Urban Roads Authority was established under Section 9 of the Kenya Roads Act, Cap 2.

4. National Water Conservation and Pipeline Corporation, wholly owned by the Government of Kenya, was established under the State Corporations Act Cap 446.

5. Kenya Petroleum Refinery Limited is a privately owned limited liability company. The Government of Kenya owns 50% of the company's equity and the other 50% is held by Essar Energy Overseas Limited. See http://www.kprl.co.ke/profile.php.

6. Kenya National Trading is wholly owned by the Government of Kenya through the Ministry of Trade, through Industrial and Commercial Development Corporation (ICDC). The Corporation has specific objectives, the most important of which is promoting and growing wholesale and retail trade, but not including motor vehicles. See http://www.kntcl.com/.


8. Kenya Railways Corporation is a State Owned Enterprise. See http://krc.co.ke/


10. Non-controlling shareholding in companies in the sector.


12. The Kenyan government also operates state hospitals including Kenyatta National Hospital and other referral and provincial hospitals.
Annex 3: Importance of the Analyzed Sectors

A first proxy to assess the relevance of the analyzed sectors within the Kenyan economy is the impact of each sector in terms of value added to the Gross Domestic Product (GDP). This indicator confirms that the agriculture sector is the main driver of GDP in Kenya.

Sound economies contribute to the creation of job opportunities for citizens, and effective competition in the business environment might drive workforce development, higher level of productivity, and higher wages. The “employment by sector” indicator compares the number of workers by industry in 2013. In line with the considerations on added value, agriculture, after the informal sector, is the area of the economy that employs the largest number of Kenyans, and represents an increasing trend.

Another measure that can be used as a proxy embodying the relative importance of sectors, in terms of consumer spending, is the consumer price index (CPI) weight assigned by the KNBS to some groups of commodities in order to compute the consumer price index. The CPI measures changes in the prices of goods and services that households consume. In practice, CPIs are calculated as weighted averages of the percentage price changes for a specified set or “basket” of goods and services.

Finally, some sectors are important since they determine the competitiveness of other sectors in the economy given that they are important inputs for production. Therefore, the cost of those inputs in the operating costs of business provides another relative measure of the importance of a sector.
### Table 7: Relevance of Sectors Analyzed to the Kenyan Economy

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>Agriculture and forestry: 25.3%</td>
<td>Agriculture, forestry and fishing: 346,700 (Percentage increase from 2010: 4.65%; Coverage of total employment: 15.30%)</td>
<td>Food and non-alcoholic beverages: 36.04</td>
<td>N/A</td>
</tr>
<tr>
<td>Electricity</td>
<td>Electricity and water supply: 1.4%</td>
<td>Electricity, gas, steam and air conditioning supply: 14,700 (Percentage increase from 2010: 25.64%; Coverage of total employment: 0.65%)</td>
<td>Housing, water, electricity, gas and other fuels: 18.30; electricity: 1.098</td>
<td>Energy expenses: 7.31% of total costs</td>
</tr>
<tr>
<td>Electronic Communications</td>
<td>Transport and communication: 9.1%</td>
<td>Information and communication: 92,700 (Percentage increase from 2010: 19.00%; Coverage of total employment: 4.09%)</td>
<td>Communication: 3.82</td>
<td>ICT costs: 0.88% of total costs</td>
</tr>
<tr>
<td>Insurance</td>
<td>Financial intermediation: 4.8%</td>
<td>Financial, insurance activities: 67,000 (Percentage increase from 2010: 23.84%; Coverage of total employment: 2.96%)</td>
<td>Car insurance: 0.223</td>
<td>Finance and insurance: 1.74% of total cost</td>
</tr>
<tr>
<td>Professional Services</td>
<td>Real estate, renting, and business services: 4.1%</td>
<td>Professional, scientific and technical activities: 65,400 (Percentage increase from 2010: 8.82%; Coverage of total employment: 2.89%)</td>
<td>Miscellaneous goods and services: 4.52</td>
<td>Business services: 2.50% of total costs</td>
</tr>
<tr>
<td>Air Transport</td>
<td>Transport and communication: 9.1%</td>
<td>Transportation and storage: 76,400 (Percentage increase from 2010: 8.06%; Coverage of total employment: 3.37%)</td>
<td>Transport: 8.66</td>
<td>Total transport costs: 3.45% of total costs</td>
</tr>
</tbody>
</table>


3. The weights reflect the relative importance of each good in household consumption in a given period. In light of the methodology adopted, it seems reasonable to look at the CPI weight in order to understand which are the goods and services (and the related economy sectors) that are likely to affect consumer spending the most. Data source: KNBS, CPI and inflation rates for February 2015, available at http://www.knbs.or.ke/index.php, retrieved on 23 March 2015.

4. This variable measures the impact of cost of energy, ICT, insurance, and business services on the overall costs of Kenyan firms. Costs are expressed as a percentage of total costs; total costs were calculated as the sum of the following: (i) labor costs, (ii) total cost of materials, (iii) energy related expenses, (iv) transportation costs, (v) ICT costs, (vi) financial costs, (vii) rent and building equipment, (viii) business services, (iv) R&D, and (v) others. Data source: 2010 Economic Census Data.
Annex 4: Sector-Specific PMR Methodology

The sector specific indicators have been calculated in line with the OECD methodology to compute indicators of regulation in non-manufacturing sectors. The figures below summarize the components of each indicator. The specific questions, scores and weights can be found at http://www.oecd.org/eco/reform/Schemata_NMR.xlsx. For further details see Koske, Wanner, Bitetti, and Barbiero (2015), “The 2013 update of the OECD product market regulation indicators: policy insights for OECD and non-OECD countries”, OECD Economics Department Working Papers No. 1200.
Annex 5: World Bank Group Estimates of Reform Impact on GDP

To determine the impact of pro-competitive reforms in other industries it is key to differentiate between service intensive industries (which will be more affected by restrictive service regulations) and non-service intensive industries. If regulations restrict the service industry, it is expected that the difference in growth between sector-intensive industries and non-intensive service industries will be larger than the efficient value for the market.

Literature shows how much a sector intensive industry could grow if regulations were removed. In particular, Barone and Cingano (2011) estimate that the value added growth differential is approximately 0.8 percentage points in a country with regulation of professions at the 25th percentile of restrictiveness according to PMR (as in UK), compared to a country close to the 75th percentile (as in Spain).

The WBG developed a methodology in order to identify the potential impact on value added of service sector liberalization. The following WBG methodological steps are applied:

1. Measuring the value added created within the service sector and through input of services for other sectors (input-output matrix or social accounting matrix). Input-output tables measure how many dollars (or respective national currency) worth of inputs from each sector was required during one year to produce the total value of outputs in one particular sector.

2. Calculating the technical weights with information on the input-output matrix. Technical weights express how many dollars’ worth of inputs from one particular sector are necessary to produce one dollar worth of output in another sector.

3. Classifying sectors or industries as “service-dependent” if the technical coefficient of service inputs for this industry is above the average technical coefficient of service sector inputs.

4. Multiplying the value added of sectors that are dependent on the use of professional services by the coefficient that captures the additional value added growth associated with a significant decrease in relative regulatory restrictiveness (a significant decrease in relative regulatory restrictiveness is defined as an improvement of at least two quartiles in the distribution of countries according to their regulatory restrictiveness). The value added growth differential of this coefficient was estimated by Barone and Cingano (2011) as 0.8 percentage points on average, 0.75 for professional services, and 1.4 percentage points for energy.

Results
Based on the 2003 Social Accounting Matrix, in Kenya there are 10 sectors that use electricity services intensively and 15 sectors that use other services intensively.1 If the electricity and professional services sectors grow in terms of value added by 0.75 percentage points following a significant pro-competitive reform effort, the additional GDP (at market prices) generated would be USD 218 million (equivalent to 0.39 percentage points of additional GDP growth).

Caveats
This is a conservative estimate, as technical coefficients are likely to be downward biased.

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1 The sectors that use electricity intensively are education, health, public administration, finance, communications, transport, hotels, manufacturing of non-metallic products, manufacturing of sugar, bakery and confectionary products, and electricity. The sectors that use other services intensively are transport and production of agriculture products.
### Annex 6: Designing Pro-competitive Regulatory Alternatives

#### SAMPLE CASE OF METHODOLOGY TO IDENTIFY PRO-COMPETITIVE ALTERNATIVES

Outlined below is an example of a set of questions and issues applied to the case of strict licensing requirements that can be used to identify appropriate pro-competitive alternatives or to minimize the distortions resulting from such license requirements.

<table>
<thead>
<tr>
<th>Question / Issue</th>
<th>Guiding questions to identify an appropriate solution</th>
</tr>
</thead>
</table>
| a) What is the policy objective pursued through the introduction of licensing procedures? | i) Market failures:  
(1) Externality: check whether less restrictive regulatory measures such as standards, performance regulation, or the creation of property rights are possible  
(2) Information asymmetry:  
(a) Introduce mechanisms to increase information available to market players  
(b) Consider standard setting procedures, codes of conduct. |
| b) If licensing procedures seem appropriate, check the implementation details. | i) What is the scope of the license?  
(1) Verify that the license does not extend to ancillary activities that do not require a regulatory intervention.  
ii) What are the conditions set by the regulation to obtain a license?  
(1) Remove numerical restrictions whenever possible  
(2) Set transparent and objective/non-discriminatory criteria to grant licenses  
(3) Remove excessive red-tape and streamline licensing process as much as possible.  
iii) Is it possible to trade licenses?  
(1) Allow secondary markets when feasible  
(2) Guarantee that there exist appropriate measures to avoid hoarding. |

#### MARKET OPENNESS PRINCIPLES TO IDENTIFY PRO-COMPETITIVE ALTERNATIVES

The OECD market openness principles are a policy instrument for governments wishing to ensure that domestic policies efficiently achieve their set objective without imposing unnecessary burdens to the economic activity or generating obstacles to the achievement of other policy objectives.

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**Disclaimer:** The information provided is for general guidance and may not be applicable in all situations. Always consult with legal and financial professionals before implementing any regulatory changes.
These principles are intended to support countries to reap the benefits of international competition and can also be considered when designing regulatory instruments:

- Transparency and openness of the regulatory process to affected and interested parties, including foreign parties (the transparency principle);
- Effective equality of competitive opportunities between like goods and services irrespective of origin (the non-discrimination principle);
- Avoidance of trade-restrictive effects that go beyond what is necessary to ensure achievement of the desired regulatory objective. This principle calls for the use of performance-based rather than design or descriptive regulations, and for reducing as a priority matter regulatory barriers to trade and investment arising from duplicative or outdated requirements;
- Use of internationally harmonized measures (the harmonization principle);
- Recognition of the equivalence of other countries’ regulatory measures and of the procedures and results of conformity assessment (the mutual recognition principle);
- Application of competition principles in an international perspective.

These principles also form part of the APEC-OECD Checklist which provides a tool for economies to evaluate their regulatory reform efforts and highlights key issues that should be considered during the process of development and implementation of regulatory policy.
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References

References

References


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• UN, 2014. UN Comtrade Database.


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