The POINT

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Policy Priorities Towards Kenya's Economic Recovery

Since the introduction of multi-party politics in Kenya, the national elections have been characterized by deep anxiety. However, the elections held at the end of 2002 were especially tension prone because of the impending retirement of the incumbent president and the on-going constitutional review process. However, a new government was elected and the anxiety reduced. The Institute of Economic Affairs invited ***Prof. Peter Anyang' Nyong'o*** (Minister of Planning and National Development) to make the keynote address at the annual lecture held on the 29th January 2003. ***Mr. Kithinji Kiragu*** (Partner, PriceWaterhouseCoopers) and ***Dr. Andrew Mullei*** (Executive Director, Africa Centre for Economic Growth) responded to the Minister's address on the state of the nation and the governance priorities. The Point highlights the discussion below.

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Introduction

The national elections took place amidst political and economic uncertainty. Kenya's political landscape was highly tense while the economy had began to contract. However, the elections were relatively peaceful and the whole county was quite relieved. This moment was historic because there was not a change in the presidency, but a virtually new political party succeeded the Kenya African National Union (KANU) in government.

In spite of the fact that the peaceful political transition eased the political tension, many Kenyans were still anxious due to the precarious state of the economy. With this in mind, the principal task facing the new government was an incisive assessment of the state of the economy before the proclamation of the main policy priorities that will be pursed.

The economic problems facing the country in January 2003 were widely acknowledged by virtually all the political parties. Any new administration would have felt compelled to make an assessment of the state of the country and attempt to realign the party manifesto to the needs and priorities that it identified. Government planning needed to be based on the most accurate picture of the state of the Kenyan economy.

The political administration found two inconsistent trends:

- The country had attained a stable macro-economic framework visible through indicators such as stable exchange rate, good level of foreign exchange reserves and low level of inflation at 2% in 2002.
- Poor performance in the real economy. For instance, the levels of economic growth had been

declining and averaged 1.04% over 1997-2001. In addition, there was a decline in investment and saving rates, declining export performance and rising unemployment and poverty.

In essence therefore, Kenya kept control of the important macroeconomic parameters such as inflation, foreign exchange reserves and a stable exchange rate without making these translate into growth and employment. While macroeconomic stability is desirable as a target, this situation provided proof that it is hardly sufficient in terms of ensuring that broad growth in either the gross domestic product or employment occurs. It emerges therefore that there must be a broader view of economic indicators in order to realize the acceptable levels of investment, savings and employment to facilitate a healthy economy. With this backdrop, it is evident that the elections took place in an exceptionally difficult economic atmosphere.

The incumbent government has insisted that the preoccupation with the macroeconomic stability had diverted the last government from the need to create conditions necessary for growth. As a statement of the immediate goals, the NARC (National Rainbow Coalition) manifesto recorded that the rehabilitation of the national economy and the sustainable reduction of poverty were among the main issues that would be taken up as matters of priority. The wide mandate from the electorate came with obvious expectation in the resumption of rapid economic growth, increased democratization, good governance and public sector transparency. All these broad goals were to be achieved within an existing policy framework and the new policy dispensation that would be promulgated by the new government.

All these factors together have led to a national environment that is hostile to sustained economic activity in general. Government has been unable to ensure that the security of people and their property and this has characterized Kenya as a hostile environment for business activity. Response to these issues must be by the provision of incentives for individuals and firms to create wealth. Apart from the proposed incentives, the issue of the security of people and their property should be ensured because business activity suffers from seasonal or permanent insecurity in many parts of the country.

Relevant Policy Documents

While most of the contesting parties had drawn elaborate manifestoes, it was not always possible to understand what their priorities would be. Virtually all manifestoes drawn by the different political parties emphasized the need to increase the rate of economic growth through the creation of employment and the reduction of corruption in both the public and private sector. Private sector organizations and individual Kenyans commented that the manifesto presented by the NARC before the elections made modest promises on economic reconstruction. This assessment arose from the general view that the country's socio-economic indicators were so bad that the turnaround required a very radical set of policies to reverse the decline.

This criticism of the manifesto is justified because whereas it notes that the economy has been in decline since independence, it prescribed no radical measures to halt the secular decline and ensure that growth would be maintained for the long-term. Indeed, the most impressive proposal in the manifesto and economic blue print was the promise to create about half a million jobs per annum for the entire term in government. The main question was that the mechanism for the creation of these jobs and simultaneous maintenance of a growth rate of 7.5% per annum were not articulated in either the economic blue print or the manifesto.

Ü *PRSP*

The Poverty Reduction Strategy Paper (PRSP) is an important policy document since its development was the result of widespread consultation of Kenyans and also because it responds to the most urgent development problem facing the country. To the extent that is possible, all policies must be made to respond to acute levels of poverty in Kenya. Granted that the main challenge appears to be that of responding adequately to the extreme poverty levels in Kenya, the most obvious policy would be that directed towards generating and sustaining growth.

Part of the reason that poverty grew substantially in Kenya is because of the fall in agricultural production and failure of other public services to the poor in Kenya. Economic growth will ensure that most of the socio-economic goals are achieved. Economic growth is thus a central pillar increase in revenues while allowing individuals to meet most needs with their own resources.

Strategy

Ü ***Infrastructure***

The government also expressed interest in refurbishing the infrastructure network in Kenya. Among the leading suggestions was to construct a dual carriage way from the port of Mombasa through Nairobi and Kisumu to Busia on the border with Uganda. If undertaken, this would be the largest infrastructure project that the government of Kenya has ever embarked upon. The rationale for this undertaking is clear to the government because of the need to improve the state of the road linking the main cities in the country and to expand the road network in order to allow for faster and safer movement of traffic.

This project is also justified by the fact that the port of Mombasa is the main gateway into the East African Community and further into some of the central African countries. The strategy for its construction will involve innovative ways of construction and the use of concrete as the surface material. From this, it is expected that the local demand for cement will increase and provide an opportunity for local and regional cement manufacturers to exploit.

The new government also recognizes that telecommunications infrastructure has been in need of improvement. Radical reforms were proposed with the most evident being the promise to license a third company to operate mobile telephones services and the related commitment to introduce competition in the provision of internet connectivity. In the view of the NARC government, the broad intention is to improve the quality of internet services by introducing direct competition to Telkom Kenya's monopoly through Jambonet. As for mobile telephony, it is recognized that the industry has grown considerably to over one million lines since the second mobile telephones operator was licensed in September 2000. The quest to license a third firm was necessary to fulfill the requirements of the sector law that proscribed any monopoly or duopoly situation in the entire industry and also to increase the competition by enabling new investments into the industry.

Ü ***Free Primary Education***

Enrollment in primary schools in Kenya has been falling rapidly. Many factors can account for the reduced enrollment in primary schools in particular but government recognized that the main impediment was the inability of parents to afford school equipment and the fees and various levies that applied. Decline in primary school enrollment rightly concerned the government especially because by 2000, only 67.6% of primary school age children were enrolled in primary schools. This decline was of concern because as the enrollment rates were reducing sharply year after year, the government expenditure on education generally stayed within the range 15-20% range of government expenditure throughout the decade. The policy imperative in education is to raise the enrollment rates sufficiently in order to halt the decline and justify the public investment in education. This was began by the immediate institution of the free primary education programme. Government is committed to regular review of this programme o ensure improvement.

Confidence in the government has been lost due to the inconsistent policies and the endemic corruption in the civil service. The secular decline in overall economic growth was aggravated by a variety of factors but corruption has been cited as the greatest challenge of all. Corruption has not only reduced government accountability for public funds but has hindered investments and contributed to the net long-term financial outflows. Annual net outflows of official capital have averaged about 2% of the gross domestic product since 1997. On the other hand, the rise in the poverty level has also affected the savings rates by households due to the reduction in real incomes.

Ü ***Corruption***

One of the goals of the government must involve the display of visible efforts to restore the confidence of individuals and investors. This must be done through a systematic investigation and prosecution of corrupt public officers to ensure that public servants are less likely to engage in corrupt practices. In this regard, the government announced that the members of the cabinet and other elected officials will make public declarations of their wealth and existing financial interests. Other initiatives announced involved the establishment of a framework to address corruption holistically. This is to be accomplished parliament. These bills are to include the redrafted Anti-Corruption Bill to tackle economic crimes and another specifying the legal provisions for privatization of state owned enterprises.

Overcoming the Obstacles

Poor governance has been identified as the main cause of economic underperformance in Kenya. Successful government performance during the term in office will depend on the extent to which it raises the quality of political governance. The credibility of the Kenyan government has suffered from the impunity of individuals and the government as a whole in dealing with questions of justice, prudent management and transparency. As a result it has become obvious both to investors and development partners that the government is lacking the political will to carry forward the agreed reforms.

With the change in government after the elections, investors, the public and development partners are expecting the quality of governance to change significantly. Response to the issue of political governance should involve higher degree of integrity among public officials generally and the executive branch of government most especially. Improvements in political governance will inspire more confidence from the legislature and judicial arms of government by allowing a higher degree of scrutiny and genuine checks between the arms of government.

Ü ***Broad policy priorities***

The change of government that occurred from the last elections was accompanied by high expectations from Kenyans and even development partners. Due to the high expectations, government will over the next five years be faced with increased demands to accomplish certain tasks or pursue broad objectives that satisfy the interests of the citizens and partners. It is quite clear that not all these demands will be compatible. Government needs therefore to meet the challenge of competing demands by identifying the broad policy priorities.

These priorities should focus on the longer term since businesses and investors operate on long term perspectives. In this respect, this government must depart from the time horizon its predecessor and attempt to establish a clear and stable policy environment. Through clear sector and national policies, both local and foreign investment will be facilitated for the long term. Still, it is recognized that some pending issues are quite urgent and will require immediate attention but the longer term policy direction must be articulated clearly within the first two years.

Ü ***Increased investments***

In order to generate growth and have a clear effect through the reduction in the levels of poverty, government will need to overcome the general lack of investment capital. As stated earlier, investment has been affected by high levels of corruption, poor economic growth and the reduction in both government and individual saving. Increased investment is a legitimate concern and must be attended to through promoting private sector activity. This increased investment can only come from efforts by the government towards building the confidence of private investors. This can only be demonstrated through an enduring sense of conviction in turning around the economy aside from the rhetoric that the previous government expressed regularly. Part of the action needed is to begin to treat investors equally and enable individual firms to compete fairly with one another. Special tariffs imposed by the government to favor certain industries or corporations without particular regard to the full welfare effects should be leased. The lesson from their performance is that government should be impartial to all investors and ensure that no preferences are granted to select firms at the expense of others. To ensure that private sector activity is supported consistently government will need to incorporate the private sector as an important pillar in all its planning activity.

Ü ***Expenditure monitoring***

Proper use of public finances will also be targeted to stimulate savings and capital formation. By this action, government will be responding to the lack of saving by both the public sector and households. The Efficiency Monitoring Unit (EMU) will not only serve the purpose of monitoring the use of funds but will perform quality audits to determine the efficiency of expenditure within government. Through this consistent monitoring, government will be able to continually review expenditure and save on the waste of public resources.

been obvious lapses in its performance because the wastage of public finances continued to occur. Significance of the need for EMU is supported by disclosures that up to 62 billion Kenya Shillings are routinely wasted per annum. This endeavor to strengthen the EMU would address the need to ensure efficient use of public funds and maximize their positive effect.

Ü *PPPs for infrastructure financing*

Development of physical infrastructure should not be limited to the road network generally and to the proposed dual carriageway. A consolidated approach to the development of physical infrastructure requires attention to produce adequate quantities of electric power, efficient telecommunications and adequate water supply. Granted that the infrastructure requirements exceed the ability of government to pay, innovative methods for infrastructure financing must be explored. This will not only require the understanding of public sector limitations but also the definition of the roles that the private sector may play in infrastructure financing through focused Public Private Partnerships (PPPs). It is imperative that the modalities for appropriate PPPs be outlined to enable the private sector to invest in infrastructure projects throughout the country. By this approach, the infrastructure needs of the country will be met in good time without necessarily increasing the public debt. However, for these partnerships to develop, government must be willing to recognize the resource advantages that the private sector would bring to a project in terms of technical capability, technology, and the ability to complete projects promptly and cost effectively.

Ü *Government borrowing*

Heavy borrowing by government has affected the amount of credit available to the private sector. Reduction of government borrowing through short-term instruments will have the added advantage of moderating the interest rates and thereby provide the opportunity for more credit by private sector for investment in firms. From this increased investment will also raise further employment as firms expand their capacity for production of goods and provision of services within the domestic and international markets.

Ü *Enforcement of labor standards*

Labor relations in the country appear to be lacking for increases in wages. This agitation by trade unions and workers for the review of wages threatens to hinder further investment because of the perception that labor unions were demanding impossibly high wages. While negotiations between workers and the employers should not involve government, guidance in terms of clear labor laws are required to obviate unnecessary conflict. Government's role in ensuring that employers adhere to the labor laws should be taken seriously since working conditions sometimes generate conflict between the employers and their workers.

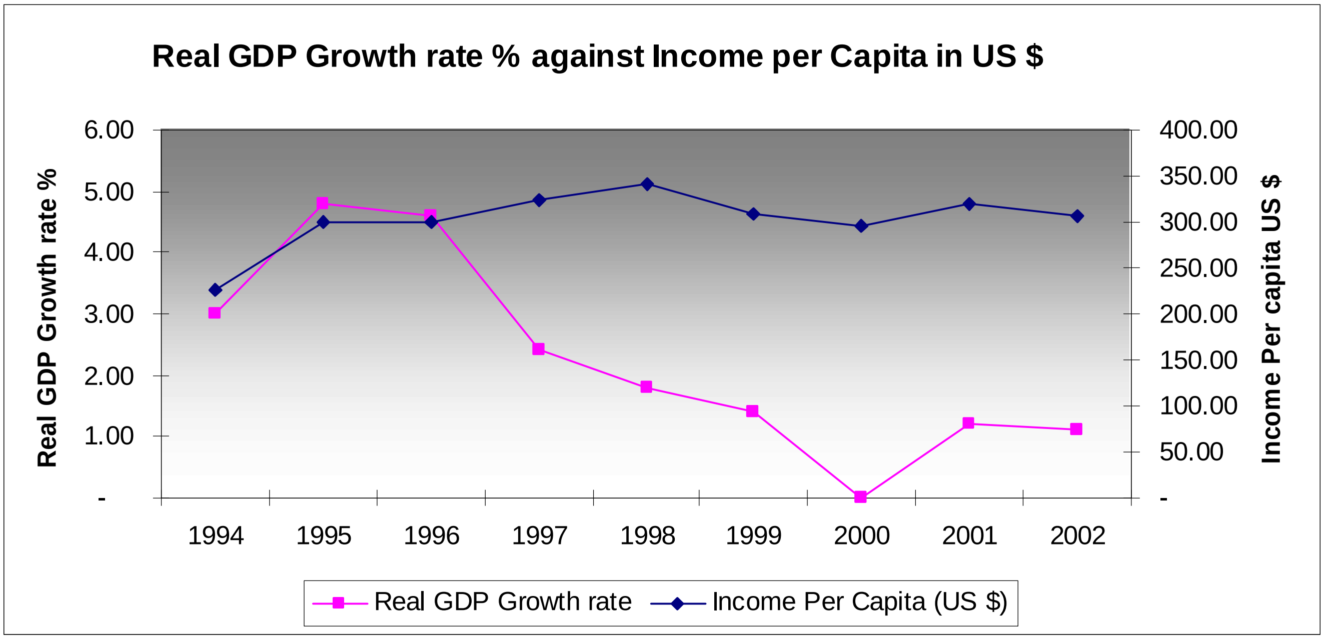
Ü *Reclaiming development agenda*

Many Kenyans are of the view that the national development agenda has been ceded to development partners and donors. In many areas, Kenyans have observed that government has not been the leader in providing the solutions to public problems and that the development partners have used their control of finance to unduly influence decisions. Government therefore needs to shows its commitment to national development by fully reclaiming the development agenda. Because government is elected by Kenyans, it should be subject to the influence of the electorate and pursue economic objectives that increase public welfare. This demand for the government to reclaim national development agenda means that its decisions will be made subject to the domestic constituency and much less to financial institutions to which the country is indebted already. In essence, the national policies in Kenya should be determined to the extent possible by Kenyans and elected representatives and thereby reflect progressive Kenyan interests. The recommendation is for government to reform its relationship with donors and development partners.

Ü *Prudent borrowing*

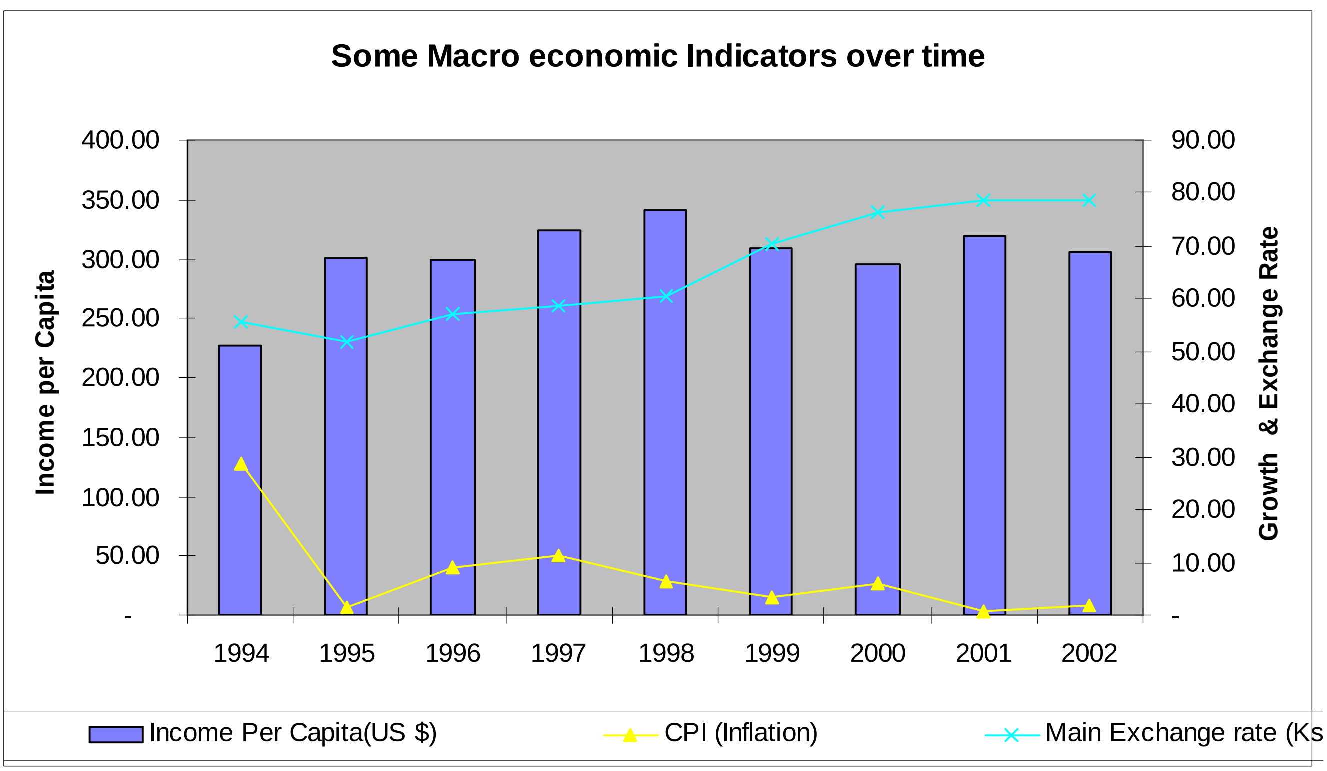
Claims that the national development agenda is unduly influenced by donors and development partners come from the heavy reliance on external funding by the previous government. Consistent partnership with the development partners to ensure financial support is commendable but should not lead to ceding of the development objectives. While the government seeks to regain a good relationship with donors generally, it is important for Kenyans to observe that the partnership is principle. Due to imprudent

Figure 1



Source: Various Issues of the Economic Survey (Central Bureau of Statistics)

Figure 2



Source: Various Issues of the Economic Survey (Central Bureau of Statistics)

government, the level of external public debt reached 37.5% of the Gross Domestic Product (GDP) without much evidence that the loans were used well. This situation means that the incumbent government bears the responsibility of limiting unnecessary borrowing and ensuring that funds are used in the priority areas that have been identified. Two objectives will be achieved by this prudent approach because the extent of indebtedness will be reduced while the funds will be well utilized to realize sustained economic growth.

Ü ***Public expenditure review***

Because the government has articulated an elaborate agenda, it is important for an audit of the civil service capacity to be conducted. These wide ranging reforms are justified but they will represent major implementation challenges because they will definitely stretch government resources and human resources capacity. This calls for the systematic implementation of the reforms in line with the identified priorities to ensure that the resources are used in the most optimal manner. Kenyans must begin to see the link between the cost of maintaining the civil service and overall economic performance. Added to this point is the larger issue of public expenditure review to determine the most appropriate use of government human and financial resources. Public expenditure review is important in the short term also because it should be used to inform the government's budget making processes.

Recurrent expenditures have for a long time been rising with the result that the public investments and savings have been insufficient. This imbalance in government expenditures between recurrent and development expenditures is illustrated by the fact that nearly 85% of the 2002-2003 Budget expenses comprised of recurrent expenditures. The implication is that government is that much less money is available for capital expenditures and savings. On the other hand, the proposed public expenditure review should aim at identifying and building the required skills and reorient the civil service towards a performance-driven culture.

Ü ***Cost of energy***

Government pronouncements state that the focus is shifting towards providing the most conducive environment possible for the private sector to lead in economic activities. One critical factor that generally and electric power in particular. Over time, the cost of electricity in Kenya has risen to the extent that many Kenyan manufacturers are unable to produce goods as competitively as other countries in the COMESA region and the rest of Africa. Manufactured Kenyan goods are increasingly becoming uncompetitive because the major competitors such as Egypt and the Republic of South Africa have far cheaper electric power costs. Manufacturing firms in Kenya therefore have urged government to reduce the costs of electricity in order to facilitate expansion among the manufacturing enterprises. This calls for a policy review of the entire electricity sub-sector so that the cost components may be examined in detail. Such a review may then lead to decisions about the choices available for the reduction in cost of electric power by taking into account the national circumstances.

Ü ***Lending to farmers***

Revitalizing the national economy would have to focus on what infrastructure can support agricultural activity. Most farmers in the rural areas are faced with the inability to access credit facilities. Assistance to the farmers and small traders will be best achieved through support and incentives to cooperative societies and Micro-finance Institutions. Government commitment to ensuring that the livelihoods of rural citizens is secured will require that access to credit services is eased considerably. By implication therefore, the monopoly for lending to agriculture that is held by the Agriculture Finance Corporation should be taken away to enable Micro-Finance Institutions to expand their lending to farmers.

Ü ***Tax policy***

Both the manifesto and the economic blue print published by the NARC reflect the commitment to substantially reduce the level of taxation when elected. This undertaking appears to have been informed by the popular feeling that taxation levels in Kenya are very high. This promise to cut taxes all round appears to conflict with the fundamental logic of other government promises and the real financial position. Among other regular commitments, the construction of the dual carriageway and the institution of the free primary education scheme will exert tremendous pressure on government finances. With these goals in mind, it is unlikely that government will accomplish them when faced with reduced revenue.

It is of essence therefore for the government to consider the implications that the immediate reduction on levels of taxation will have in both the short and medium term. Also, in comparative terms, the proportion of taxation to the Gross Domestic Product for Kenya may be comparatively high within the region but this does not necessarily reflect a very high level of taxation. The resolution of this tension will only abate when Kenyans are able to see that the quality of public services matches the levels of taxation. The taxation policy should not be skewed towards certain sectors and corporations but government must recognize the circumstances may not permit the reduction in taxes that had been contemplated.

Ü ***Integrating the economy***

In recent years, the poor economic performance has been accompanied by rising unemployment. This was due to the poor economic performance and increased poverty which affected the formal sector firms. However, while employment has been contracting in the formal sector, the informal sector has experienced rapid growth. Recognition of the non-formal sector has risen substantially as seen in the commitment by the last government to encourage entrepreneurial activity by individuals who may not have secured formal employment. The further growth of the non-formal sector in the economy may be laudable as far as the provision of employment is concerned, but this artificial separation within the economy may retard growth.

The policy option is for government to begin to think beyond providing an incentive structure for firms and begin to work towards the integration of the entire economy. In pursuing the integration of the economy, lessons from the work of the Institute for Liberty and Democracy in Peru should be taken in. The central idea is to recognize that respect for property rights allows for the integration of the entire economy. The advantages inherent in the integration of the economy will justify the cost of beginning the implementation of the reforms necessary for transformation of the large non-formal sector.

Conclusion

The change in political leadership in Kenya provides a new atmosphere for new approaches to the socio-economic problems facing the country with the min policy priorities have been defined in the various policy documents, the main role of the government must be the task of raising the growth levels. This can be accomplished by the provision of public services as security, healthcare, infrastructure, education through a working civil service. Most important though is that this government must consider new approaches to tackling the numerous challenges it faces by looking to the private sector to lead in economic activities.

Finally, in view of the optimism that exists, it is essential for the government to make optimum use the opportunities that exist to get the whole country towards growth again and change the state of the nation.

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