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# **Review of Government Policies for the Promotion of Micro and Smallscale Enterprises**

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## ABSTRACT

The Micro and Smallscale Enterprises' (MSEs) sector in Kenya has grown tremendously over the last two decades despite poor policy conceptualization and implementation in the sector. However, this growth is characterized by low productivity and survivalist activities despite the fact that this sector is very strategic in providing future employment. This paper reviews the evolution of policy in the MSE sector, the impediments to policy implementation in this sector, and makes recommendations for the development of this sector. The paper notes that the support framework pursued since 1986 in this sector has been characterized by unsustainable subsidies and stop-go policies that emanate from an inadequate understanding of the sector and its relationship with the rest of the economy. The mismatch between policy pronouncement and resource allocation—capital financial and human—has brought about poor implementation of these policies. The problems that inhibit the growth of the MSE sector still persist three decades after they were recognized.

Despite the general failure of policy implementation, the government considers the sector as the source of future employment generation. However, the sector must increase its competitiveness for it to fulfill its role in employment creation. Recent trade liberalization policies have opened new opportunities for MSEs and created new competitive pressures. Further, the limited access to capital and financial services arising from institutional and legal impediments to commercial lending to the MSE, and the poor infrastructure has made it difficult for the sector to adjust to reforms. Since the productive sections of the sector have stagnated despite the incentive-based approaches embedded in the liberal policies, the paper proposes government intervention in building capabilities of enterprises in order to boost competitiveness. This will involve building up human capital, technological capabilities and institutional structures to facilitate effective functioning of markets.

The paper also recommends creation of a conducive environment and incentives for the formation of industrial structures rich in linkages among MSEs and between MSEs and large enterprises. Finally the paper notes that efforts towards the promotion of the MSE sector and poverty reduction need to go hand in hand with other policies of raising rural incomes. Raising rural incomes is essential in stimulating demand for off-farm employment and this implies improvement of agricultural competitiveness, increasing farmers' access to credit and input, providing marketing services and investing in rural infrastructure. Business development services would have to increasingly adjust their supply to rural-based MSEs. Although the cost of such interventions may be high, sustained growth of the sector can only be achieved by creating conditions that increase the productivity of the rural areas.







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# 1. Introduction

Many developing countries have large and growing Micro and Smallscale Enterprise (MSE) sectors. In Kenya, the MSE sector is the biggest employer outside agriculture. According to computations from Economic Surveys, for example, the MSEs' share of total non-agricultural employment in 1999 was 68.2 percent<sup>1</sup> up from 48.9 percent in 1993. This phenomenal growth in the MSE sector has increased policy focus on the development of this sector as an engine of economic growth, employment creation and poverty reduction. This is in line with the government's objective of making the private sector the key source of future growth.

Lack of coordination of the various implementing agencies, poor resource management, and lack of enthusiasm by policy makers to encourage the growth of the informal sector in urban areas may explain the poor implementation record in the MSE sector. This may also be due to a perception among policy makers that the sector signifies failure in other areas. From a cursory glance at national statistics, economic growth has not been able to generate the kind of jobs desired by many and as the agricultural sector has stagnated, the informal sector has grown. Poor implementation of MSE policies could also be attributed to the considerable ambiguity concerning the definition of micro and smallscale enterprises, which makes targeting of the right enterprises difficult.

This paper seeks to review the policy framework in the MSE sector since independence with the aim of showing the continuities and discontinuities of policy formulation and implementation on MSEs and

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<sup>1</sup> This figure however differs highly from the figure given in the Baseline Survey of 1999. In the Survey, the informal sector is said to contribute 36.4 percent of non-agricultural employment. This discrepancy can be attributed to lack of comprehensive data on the informal sector at the national level.

their probable effect on the growth of the sector. The paper considers definitional issues and a brief conceptual framework on issues surrounding policies on the sector. The paper then traces the evolution of policy from 1973 to date and provides an overview of the sector and the nature of impediments that have stifled growth of firms. A brief critique of the policy framework is made and conclusions and recommendations drawn from the analysis.

### **1.1 Definition of the MSE sector**

Numerous efforts have been made by academics (Mead and Morrison, 1996) and also policy makers (Visser, 1997) on the definition of this area of economic activity. However, three criteria are mainly used in literature to define Micro and Smallscale Enterprises (MSEs)<sup>2</sup>. The first one, based on number of employees, defines MSEs as those enterprises below a certain number of workers (it can range from less than 10 to less than 50 employees). The second criterion concerns the degree of legal formality and is mainly used to distinguish between the formal and informal sectors. According to this criterion, MSEs are those enterprises that are not registered and do not comply with the legal obligations concerning safety, taxes and labour laws. The third criterion defines MSEs by their limited amounts of capital and skills per worker. The degree of informality and size of employment have perhaps been the two most readily accepted criteria on which classification of MSEs is based.

For the purposes of this review, we will adopt the criterion of number of employees which is also the definition used in the MSE National Baseline Survey of 1999. In that Survey, MSEs are defined as those non-primary enterprises (excluding agricultural production, animal

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<sup>2</sup> See Morisson (1985) and Bigsten et al. (1999).



husbandry, fishing, hunting, gathering and forestry), whether in the formal or informal sector which employ 1-50 people. Micro-enterprises are those that employ 10 or fewer workers and smallscale enterprises are those that employ 11-50 workers. According to the 1999 National Baseline Survey and many other prior studies, only a small proportion of MSEs employ 11-50 people.

The term MSE incorporates firms in both the formal and informal sectors. However, the terms MSEs and informal sector are normally used interchangeably as most MSEs are informal enterprises. Informal sector firms are characterized by: ease of entry; small scale of activity; self employment with a high proportion of family labour; little capital and equipment; labour intensive technologies; low skills; low level of organization with little access to organized markets, informal credit, education and training or services and amenities; cheap provision of goods and services or provision of goods and services otherwise unavailable; low productivity and low incomes (Charmes, 1997 as quoted in the National Baseline Survey, 1999). The activities of MSEs also have very little compliance with administrative requirements. What distinguishes the informal sector from the formal sector is that the former are mainly unincorporated business units of the household sector.

The informal sector is itself roughly divisible into two: the small informal productive sector and the mainly survivalist activities. The small informal productive sector are those elements of the informal sector as distinct from survivalist activities which are given such description as "sustainable"; "emergent" or "entrepreneurial". The incomes from these enterprises can be significantly higher than those of the lower ranks of the formal sector. Such enterprises are considered important for poverty alleviation and are important producers of goods, services and employment. Survivalist activities are, on the other hand, engaged primarily in commerce but are mainly involved in basic and low quality

forms of production with the intention of earning income to meet subsistence needs.

Formal smallscale enterprises are similar in characteristics to those found in the industrialized economies to the extent that they are skill intensive, conform to regulations, use high levels of human capital, and are integrated into the structures of the formal economy. They are a reservoir of skills and are often excluded from discussions of informal sector or poverty alleviation. There is ongoing debate whether these segments are rigid with significant barriers between each of them or are simply modal points along a continuum.

The MSE sector provides certain benefits to the economy that directly derive from the characteristics highlighted above. Key among them is the recognized potential of the MSE sector to generate incomes and provide jobs to a large number of Kenyans. The 1992 Sessional Paper on MSEs highlights other benefits that make promotion of MSEs crucial to the development of a labour-surplus (primarily agricultural) economy such as Kenya's. These benefits include:

- MSEs contribute significantly to the economy's output of goods and services.
- MSEs save on scarce capital in creating jobs.
- The MSE sector has been the primary source of developing a pool of skilled and semi-skilled workers and entrepreneurial talent who are an important base for future industrial expansion.
- The MSE sector has been used to strengthen forward and backward linkages among socially, economically and geographically diverse sectors of the economy.
- The sector constitutes an important market and supply point for rural enterprise products, which are predominantly marketed to rural households.

- MSEs promote rural-urban balance by supporting industrialization policies in the rural areas.
- Because of their structure and ownership they are flexible and can adapt quickly to market changes.

## 1.2 Conceptual Framework<sup>3</sup>

The earliest thinking on the MSE (informal) sector was motivated by the dual economy model a' la Lewis (1954). In this model, the economy is divided into two sectors: a subsistence (traditional) sector which acts as a reservoir of surplus labour, and a more capital-intensive and productive modern (industrial) sector. The modern sector is assumed to have higher wages and is expected to attract labour from the subsistence sector over time. In this model, the subsistence sector is seen simply as a feature of the temporary disequilibria experienced by the economy, which is expected to disappear as the economy modernizes and the industrial sector absorbs surplus labour. The natural policy prescription arising from this was to ignore the existence of the informal sector, as it would disappear with time.

This policy conclusion occasioned much debate in international policy circles involving major international agencies such as the International Labour Organization (ILO) and the World Bank. The ILO, through the famous 1972 report on unemployment in Kenya, rejected the modern-traditional dichotomy which cast the informal sector as retarded and instead advocated for support for the sector as a dynamic source of future growth in Kenya (ILO, 1972). The World Bank's view on the other hand was decidedly different; it advocated less government intervention in the sector (World Bank, 1999). The World Bank argued that much of the intervention on the sector in many countries was haphazard and

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<sup>3</sup> Part of this section borrows from Wuyts (2000).

characterized by unsustainable policies. It went further to state that successful development strategies for the MSE sector should characteristically be three pronged: creating a level playing field, carefully targeting public expenditure to use scarce public resources effectively, and encouraging private provision of a wide array of financial and non-financial services (World Bank, 1999). Creating a level playing field should involve re-evaluating the costs and benefits of regulations that place a disproportionate burden on MSEs, implementing regulations with the flexibility needed by MSEs, and placing greater emphasis on competition and procurement policies to open MSEs' access to markets. Efficient targeting of public expenditure should be confined to those services and target groups that are under-served by the market, while government should strive to develop private markets for services suitable to MSEs, therefore stimulating market development on both the demand and supply side.

Despite its widespread influence on policy thinking on the informal sector, the dual economy model can be faulted on two grounds with respect to explaining the nature, emergence and growth of the informal sector in Kenya. First, it tends to ignore the fact that in many developing countries like Kenya, many households and individuals engage in multiple productive activities that cut across both sectors. According to McCormick (1988), many of the owners of urban smallscale enterprises also own farms in the rural areas in which some members of the household work—a practice termed as “straddling.” Straddling is important because it enables modern sector workers to survive on low wages, which effectively acts as a wage subsidy to the sector. It also allows the owners of these businesses to reduce some of the risk associated with dependence on wage employment.

Second, the dual economy approach ignores the social and historical circumstances—unique to each country—that explain the emergence and growth of the informal sector. In Kenya for example, the policies of the

colonial administration, legislation enacted soon after independence and various government interventions aimed at indigenizing the economy led to the rapid growth of the MSE sector. The legislation includes among others: the Trade Licensing Act (which limited business in non-metropolitan areas to indigenous Kenyans and in the process introduced a whole array of restrictions); the Immigration Act (which required resident non-citizens to obtain work permits); the Land Control Act (which limited land ownership to citizens); the implementation of the recommendations of the Ndegwa Commission (which allowed Civil Servants to engage in business); and the creation of government monopolies that were specifically targeted at assisting Kenyan Africans to develop their businesses. The net effect of this was that the MSE sector grew immensely as many of the resident non-citizens sold their businesses and left and as Kenyans increased their participation in business.

Another model used to explain the rise of the urban informal sector is the rural-urban migration model attributed to Todaro (1969) and Harris and Todaro (1970). According to this model, the migration from an unproductive rural agricultural sector (where the majority live) to a more remunerative industrial (formal) sector where wages may at times be higher due to the government minimum wage legislation, results in an urban informal sector. This occurs because potential immigrants compare their expected incomes for a given time horizon in the urban sector with the prevailing average rural incomes and migrate if the former exceeds the latter, resulting in the formation of an urban informal sector. Policies towards the informal sector were therefore based on the official perception of the trade-off between encouraging employment and discouraging rural-urban migration. As such, the existence of the informal sector was perceived as dependent on the existence of the formal sector.

With the onset of Structural Adjustment Policies in the 1980s, a new way of looking at the MSE sector especially in relation to the rest of the economy has emerged. These theories (Wuyts, 2000) consider the nature of the policies on the sector to depend on the extent to which the sector is demand or supply-constrained. If the activities of the sector are mainly labour intensive, there is an infinite supply for its goods because of the surplus labour in developing countries. Demand-enhancing policies are prescribed to induce growth in the sector. If on the other hand the activities of the sector are constrained by lack of competitiveness or productivity collapses, supply-enhancing policies are prescribed. Wuyts (2000) distinguishes between the different types of demand-enhancing policies prescribed which depend on whether or not the informal sector is assumed to be a leading sector.

Assuming that the informal sector is not a leading sector of the economy, and therefore not an engine of economic growth, and only responds cyclically to the consumer demand originating from the leading growth-promoting sector—either export agriculture or industry—then policies that support the growth of the formal sector will also support the informal sector. The resulting increase in formal sector employment will lead to income growth and, through the multiplier effect, to an increase in the demand for informal sector goods. Because the informal sector is assumed to produce non-tradable goods with limited substitution possibilities with imports, its expansion is only limited by the expansion of the formal sector. As such, fluctuations in the formal sector, especially those affecting employment and wages, will be transmitted to the informal sector. Unemployment in the informal sector will therefore result from a contraction in the demand for its products in the formal sector (Wuyts, 2000).

If the informal sector is considered to be a leading sector and therefore a source (and engine) of growth, it will have its own dynamic propelled by its exports, consumption and imports. It is therefore independent of

the official economy and as such there is little covariance between the evolution of the official economy and that of the informal sector. A crisis of the official economy may therefore not be a crisis of the informal sector. An expansion of export opportunities may lead to an expansion of the informal sector quite independent from what is happening to the official economy.

However, this predicted outcome ignores the commonly observed phenomenon in developing countries where, as the formal sector (for example import substitution industrialization) contracts, the number of informal sector activities tend to increase. But since the new activities are mainly 'survivalist' and are aimed at stemming some of the hardships that result from unemployment, this increase is not consistent with an expansion of the informal sector and especially where there is no unemployment insurance. Although starting these 'survivalist' activities is counter-cyclical, the expansion of the informal sector itself is pro-cyclical because it depends on the demand from the exogenous formal sector. As such, the lateral expansion observed from recent statistics of the informal sector in Kenya may be explained by the increase in 'survivalist' activities as a way of coping with hardship.

Despite the focus on demand-enhancing policies, too much emphasis on such demand side policies is too restrictive because the informal sector may suffer from a supply constraint (Wuyts, 2000). Policy prescriptions that focus entirely on the demand side miss out the possibility that there may be other factors that determine the viability and competitiveness of labour-intensive production in the informal sector. They do not take account of, for example, the effect of productivity on competitiveness. Supply side policies on the other hand focus intervention on providing human, financial, technological and physical resources to support the growth of small enterprises. The basic rationale behind such policies is that if these resources are inadequate, then small enterprises will be unable to meet the demands of the market

or compete effectively with imported goods or those from the formal sector. There is however some disagreement or confusion concerning the exact nature of the assistance that should be given and the intervention necessary to boost supply. Some of the questions centre on the nature of the skills required and how these can best be acquired. There is also debate on whether formal education or informal technical education is more effective to the success of an enterprise, and on how entrepreneurial skills can be nurtured. These issues should constitute the framework for the supply-side policies of the MSE sector.

More recent attempts at theorizing the growth of the informal sector in developing countries in general and Kenya in particular have considered two factors that take account of more recent events. First, adjustment programmes have resulted in widespread retrenchment both in the public and private sectors. Retrenched workers have sought alternative employment in the informal sector. Second, as the process of globalization intensifies, and with it the global competition in labour-intensive manufacturing, large enterprises have sought and will continue to seek to evade mandated protections to labour by subcontracting to unprotected labour in the informal sector, therefore leading to the growth of the informal sector (Maloney, 1999).



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## **2. Evolution of Policy in the MSE Sector in Kenya**

Policy towards the development of the MSE sector in Kenya has varied since independence. The official stance towards the MSE sector changed only with the publication of the ILO report in 1972. Soon after, official policy documents began to reflect the change in attitude. However, there was hardly any concrete programmed support for the sector until the publication of Sessional Paper No. 1 of 1986.

### **2.1 Encouragement of Modern Smallscale Enterprises: 1964-1972**

The Sessional Paper No. 10 of 1965, released at independence, advocated a mixed economy approach to economic management. Government policy sought to bring about the indigenization of the Kenyan economy by encouraging private enterprise. The policy framework traced out in this document envisaged an economy that would be dominated by Africans.

Although the government had specific policies to encourage Africanization of commerce and industry, policy on small enterprises did not initially envision informal sector enterprises. Indeed, the thrust of the policy framework was to replace white-owned largescale enterprises with African-owned enterprises of the same size. Support for small enterprises was only mooted to achieve Kenyanisation of the economy after it was realized that this would not be forthcoming from large enterprises which policy makers had previously targeted. This policy therefore systematically undertook to support the growth of “modern” small industries mainly owned by indigenous Kenyans. Government intervention was in the form of financial, infrastructure, legal and regulatory support to the sector. A number of government financial institutions were created with this specific goal. The Kenya

Industrial Estates (KIE), set up in 1967, had the objective of achieving industrialization by providing infrastructure and financial support to small indigenous entrepreneurs to enter into the manufacturing sector<sup>4</sup>.

To achieve its vision, KIE built industrial estates in the major towns in Kenya as well as Rural Industrial Development Centres (RIDCs) in smaller rural towns. The objective of bringing about widespread industrialization through smallscale industries was however not realizable due to a number of strategic and management mistakes in the operation of these industrial centres. The centres remained unoccupied in many instances. Further, the subsidies given to these enterprises were in many cases unsustainable and did not result in efficient and self-reliant enterprises. A World Bank assessment of KIE questioned whether the money might have been better used in building overall industrial capacity utilization.

Although KIE was initially a project under the ICDC, the latter also had its own small enterprise development programme. ICDC sought to invest, through loans and equity financing, in African-owned small and medium scale firms that had limited funds. However, frequent loan defaults led to channeling of funds to only established firms (McCormick, 1997). These institutions (KIE and ICDC) were complementary to the legislation referred to under the conceptual framework in trying to Kenyanise the economy. The legislation prohibited the participation of non-Africans in certain economic activity while the institutions sought to provide support to African entrepreneurs who could take up this chance. However, very few of the small enterprises that were being encouraged actually got established.

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<sup>4</sup> KIE was set up as subsidiary of the Industrial and Commercial Development Corporation (ICDC) which had earlier established special funds for lending to small enterprises (Ikiara, 1988).

Despite the limited success in creating modern small enterprises envisioned by planners, the government did not notice or encourage the parallel growth of the “informal sector” until after the ILO report<sup>5</sup>. Official recognition of the informal sector came only after the ILO report of 1972 which extolled the virtues of the sector and its employment generation potential. In many cases, outright hostility and harassment characterized the government response to this sector.

The ILO attitude towards the sector was generally positive, acknowledging, unlike the then prevailing opinion, that the sector was productive and using appropriate technology. It recommended to the government to be more supportive of the sector, to remove the restrictive regulations on the sector and to stop official harassment. In particular, the ILO report urged the government to substitute demolition of shanty establishments and harassment of informal enterprises with site and service schemes, security of tenure, simplifications of the trade licensing scheme, and encouragement of subcontracting between formal and informal sector firms. Noting that the informal sector had grown despite absence of government policy and in many cases government harassment, the ILO report recommended that all future government policies take account of their impact on the informal sector. However, the prospective impact of this policy on the informal sector was considered by some analysts (for example King, 1993) to be minimal. It was argued that the sector was best left alone as government intervention would destroy the creativity of the sector, which had made

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<sup>5</sup> Indeed, government reports on the informal sector prior to the ILO report had as early as 1953 (in the East African Royal Commission Report) noted the negative impact of restrictive regulations and official harassment on operatives in the sector. Later on, a report concerned with addressing the increasing unemployment among school graduates—the 1967 Report on Education, Employment and Rural Development—encouraged the promotion of the productive activities of the informal sector rather than the blind promotion of all activities in the sector. However, the recommendations of these reports did not translate into any policy action by the government.

it a special feature of the Kenyan economy. The views on the sector were therefore polarized between intervention and *laissez faire*. Subsequent government documents reflected this tension and in many cases offered few tangible proposals to assist in the development of the sector.

## **2.2 Official Recognition without Policy Action: 1973-1985**

Following the 1972 ILO mission, the government released a report on employment in Kenya that contained the government's response to the report released by the ILO mission. However, subsequent government publications contained few policy prescriptions that reflected the totality of the ILO recommendations. For example, although the Sessional Paper on employment released in 1973 contained an acceptance of the ILO report, this did not translate into any programmed support for the sector. Indeed, in the 1974-1978 Development Plan the government did not even use the term informal sector to refer to policy on the sector. Rather, the government referred to the need to stop official harassment of smallscale industries, which were really only a small part of the informal sector. This terminology showed the confusion inherent in official circles over the definition of MSEs. Several other proposals were made but not necessarily in line with the ILO recommendations.

In addition, undefined "direct assistance" was also to be provided to small enterprises all over the country. Further, an organization would be established to provide extension services to smallscale enterprises. The government also proposed to reserve some subsector of the manufacturing sector for smallscale enterprises. Further, the Small Business Development Corporation would be established, incorporating the already existing KIE and RIDC programmes, to coordinate the services to the smallscale enterprises. This last proposal by itself reflected the confusion in official circles over the development of the informal sector. For one, there was no indication that the sector referred to in the

ILO document was the one being targeted because these interventions incorporated assistance to modern smallscale industries that were already attracting considerable support from the government through the KIE and ICDC.

Although the next Development Plan (1979-1983) still had some ambivalence towards the informal sector, the proposed support structure was more comprehensive for both the modern small industries and informal sector enterprises. The government proposed to undertake a comprehensive programme for the support of modern smallscale enterprises, which would include an expanded and restructured Kenya Industrial Estates oriented towards modern small industries and the establishment of a fund to assist informal small industries. Further, a programming and evaluation section for rural and urban smallscale industries was to be established in the Ministry of Commerce and Industry to assist District Development Committees in preparing coordinated programmes for the smallscale and informal sector manufacturing sectors. Unnecessarily punitive building and health regulations were also to be removed from Local Authority statutes, and the government was to offer training programmes to small business entrepreneurs. In addition, standardization of government trade tests would be done to take account of the profiles of informal sector occupations. Training programmes to small businesses through village polytechnics, the Kenya Industrial Training Institute, and Management Training Advisory centers were also to continue. Further, credit guarantee schemes for enhanced commercial bank loans to smallscale industries were to be promoted. Sub-contracting between largescale and smallscale enterprises was to be encouraged and some informal sector activities such as handcraft producers were to be assisted to export through the Kenya External Trade Authority. These proposals reflected a lot of the recommendations of the ILO report but targeting was still

weak. In many instances, smallscale enterprises were interpreted to be modern small industries, which already faced problems.

Government support was directed more towards the small modern industries even in the fifth Development Plan (1984-1988). To overcome the prevailing ambiguity over the type of enterprises targeted, the Plan distinguished, by definition, between small and cottage industries. Small industries had higher investment and employees than the cottage industries which typically had less than Ksh 50,000 of investment and less than six (6) employees. The Plan proposed to reserve certain activities of the industrial subsector to small and cottage industries. A list of items reserved for small industries was developed and was supposed to be reviewed from time to time and published in the official Kenya Gazette. However, establishments already engaged in the production of the reserved items were not to be affected.

The failure in the implementation of past proposals was evident from the fact that the establishment of a fully-fledged Small Industries Division in the Ministry of Commerce and Industry to monitor and coordinate the implementation of development programmes of small industries and to provide assistance to the Industrial Extension Service was mooted once again.

To support growth of the cottage industry, the Ministry of Commerce and Industry, in collaboration with the Ministry of Culture and Social Services, was to prepare a coordinated plan for the development of handicraft cottage industries with the objective of diversifying production, creating design development facilities, establishing common production services, organizing craftsmen to facilitate the procurement of supplies, and providing credit assistance. Some development of typical rural small industries was also to be encouraged through the KIE.

In sum, the period between the publication of the ILO report and the release of the 1986 Sessional Paper saw a gradual adoption of the recommendations of the ILO report in different government policy documents but without much implementation as was evident from the repeated insertion of the same policy proposals in successive development plans. Implementation was also affected by ambiguity over the nature of the industries being targeted; that is whether small modern industries or the informal sector. This is clearly illustrated by the fact that the term “informal sector” was hardly used in the development plans during these years and it is only in the 1984-88 Development Plan that some attempt was made at definition. It is also instructive that the government was still convinced that the way forward was through the expansion of modern small industries through subsidized financing from organizations such as the Kenya Industrial Estates whose operational capacities were already considerably strained. What is also evident is that the government had focused on supply-side policies to address particular bottlenecks to the expansion of the MSEs. Demand-side policies such as aggregate demand expansion that occurred during this period were not explicitly targeted at the sector although it may have benefited as a result.

### **2.3 Period of Concrete Policy Proposals: 1986-to-date**

Despite the early recognition of the importance of medium and smallscale enterprise in development, it was not until 1986 (in Sessional Paper No. 1) that a firm commitment to its growth and development was made. In this document, the government underscored the importance of the sector in terms of its potential to bring about balanced rural-urban development and create non-farm employment based on its unique characteristics.

In the Sessional Paper No. 1 of 1986, the government recognized the many problems inherent in smallscale enterprises and its intricate relationship with the rest of the economy. The government, therefore, proposed policies to stimulate the growth of the MSE sector. The problem of deficient demand for informal sector goods was addressed through wide-ranging policies to raise firm productivity and income and to change the investment incentive structure in order to encourage use of labour-intensive techniques predominantly used by smallscale firms. To boost the supply of informal sector goods and services, the government proposed to reduce the tariffs on raw materials and intermediate goods used by the informal sector.

Other supply-enhancing policies in the Sessional Papers were directed at enterprises in specific sectors. Such policies included: increased access to credit; increased information on available market opportunities; improved production techniques for smallscale manufacturing; expansion of Youth Polytechnics; training focused on skill development; and relaxation of existing restrictions on informal sector activities. These policies, though not new in government policy documents, were being proposed once more because of a poor record of implementation. The Sessional Paper also proposed to establish, once more, a special task force to review all the policies to promote the informal sector. The task force duties included: review of current Local Authority bylaws and other constraining regulations that govern informal sector activities; creation of healthy legal and regulatory climate for informal sector activities by eliminating unnecessary constraints; recommending an appropriate scale of license fees and charges; and eliminating police harassment of informal sector operators such as street hawkers. This was about the third policy document since the ILO report that recommended the establishment of a body that would coordinate informal sector activities. This was a clear sign that previous proposals



to this effect had not been implemented or the implementation had been poor.

The positive attitude of the government towards the MSE sector was once again portrayed in the 1989-93 Development Plan in which the sector's potential in helping the country realize its growth and employment targets was reiterated. The strategy espoused in the Plan sought to offer direct assistance to the sector, although efforts were to be made at improving the management, handling of default problems and disbursement of loans, increasing spatial coverage, and incorporating private sector participation in the provision of help to the sector. More specifically, the government sought to improve the enabling environment for the sector by policy restructuring and liberalization covering the pricing structure, trade regime liberalization, foreign exchange management, wages and investment policies, and financial restructuring. Further, the government was to amend the rules and regulations inhibiting the development of smallscale and *Jua Kali* enterprises. The government also pledged to minimize the negative impact of unfair trade practices on the survival of MSEs. In short, the government's role was to be facilitative as reflected in a three-pronged strategy: transparent policies, appropriate fiscal policies to change the cost-price relationship in favour of MSEs, and appropriate intervention to redress capital shortage.

Other government policies towards the sector included: creating an award scheme to motivate entrepreneurs in the sector to innovate and invent; increasing provision of information on markets, materials, products and technologies in local and external markets; increasing access to suitable financial, distributive and marketing infrastructure; reviewing restrictive Local Authority by-laws such as the suspension of certain licenses; appropriate revision of building codes and increased ease of allocation of land to these enterprises; and restructuring of

financial institutions to reduce the cost of giving small loans and to enable banks to have sufficient liquidity in order to provide start up finance and short term working capital. Further, the Cooperative Bank was to be encouraged to undertake more lending to the sector.

After the 1986 Sessional Paper, the government in collaboration with the UNDP and the ILO set up a small enterprise development policy project involving all the ministries, aid agencies, representatives of industry and commerce, the banking sector and NGOs (King, 1993). As a result of this project, a set of strategies on the MSE sector, on which there was wide ranging consensus, were drawn. The set of strategies covered three areas, namely: policies for providing an enabling environment; non-financial promotional policies; and credit policies.

The enabling environment was to be improved by removing many of the macroeconomic, legal, technological and fiscal obstacles to smallscale enterprises, therefore providing demand for the MSE products. As such, the role of the government in promoting activities in the MSE sector was to be more facilitative than interventionist following previous failed attempts at promoting medium scale enterprises, notably through the Kenya Industrial Estates.

The non-financial promotional strategy aimed at alleviating the shortage of entrepreneurship, which had hindered the graduation of many micro-enterprises to medium scale enterprises. To encourage an enterprise culture in the country, the strategy hoped to incorporate entrepreneurship education in the formal educational curriculum at all levels, in actual fact supplementing the existing educational reform policies in Kenya.

The strategy to alleviate obstacles to accessing credit experienced by the small and micro-enterprises sought to change collateral policies and bank incentives to lend to smallscale enterprises.

These three strategies were translated into the Sessional Paper No. 2 of 1992 on *Small enterprises and Jua Kali development in Kenya*. The Paper outlined several policy recommendations which covered the three areas in the previous strategy paper namely: an enabling environment; credit for the MSEs; and non-financial promotional programmes. In addition, gender-related policies were outlined.

### **2.3.1 Enabling environment**

The cornerstones of ensuring an enabling environment for the growth of smallscale enterprises were:

- Investment incentives including general deregulation and liberalization of the economy, provision of investment allowances to encourage relocation, and targeted infrastructure provision and other financial incentives for rural entrepreneurs;
- Assistance with technological acquisition, development and adaptation through KIRDI and the universities;
- Improved market access for MSE products through public procurement policies that favoured MSEs, encouragement of development of subcontracting linkages with large enterprises;
- Cost-effective coordination mechanism for existing and newly formed MSE support programmes among various government agencies;
- Public procurement policies to be adjusted to increase public sector purchase of MSE products;
- Wider dissemination of information on domestic and export markets using government agencies;
- Establishment, within the Ministry of Planning and National Development, of a more cost-effective coordination mechanism

for existing and new small enterprise programmes among various implementing agencies;

- Priority funding to performing government institutions charged with small enterprise development and increased funding given to local authorities to develop urban infrastructure facilities for smallscale enterprises;
- Encourage increased representation of smallscale enterprises through formation of small enterprise associations so as to ensure more effective use of programme assistance; and
- Government to undertake a comprehensive review of all restrictive regulatory Acts and rules including licensing requirements, building codes and the Employment Act, and relax all those that unnecessarily impede the operations of MSEs.

These measures, many of which the Plan envisaged would be undertaken within a period of 12-24 months, were intended to have the impact of spurring the growth of MSEs.

### **2.3.2 Credit policies**

Shortage of credit has been identified as one of the most serious constraints facing MSEs and hindering their development (Oketch et al., 1995; Tomecko & Dondo, 1992; Kiiru, 1991). The Sessional Paper, concurring with these views, proposed policies to alleviate this problem. The paper noted that banks fail to lend to small enterprises for a number of reasons which include past lending experience with MSEs which generated a mind set in the formal financial sector about the high risk and cost of lending to the sector. Further, there were adverse regulations that restricted the flow of funds to the MSE sector. The Sessional Paper proposed that the flow of funds to the MSE sector could be increased by:

- Deregulation and liberalization of the financial sector to permit banks to charge competitive interest rates and appropriate fees in order to get a fair return on their lending to MSEs. In addition, the government was to introduce appropriate legislative changes that would allow development finance institutions to accept deposits.
- Government assisting with the sourcing of foreign loans for MSEs and bearing the associated foreign exchange risks in respect of such loans.
- Government exploring the possibility of establishing an export guarantee insurance scheme and MSE export finance scheme to increase MSE exports.
- Increased training for MSE entrepreneurs facilitated through legislative changes such as the revision of the Industrial Training Act, which would allow banks to undertake training of their MSE clients using the levy. Further, banks would be encouraged to strengthen their business advisory services to accommodate the needs of MSEs. A special training fund contributed to by the government, private sector and donor community would also be set up to help train those operating in the sector.
- Changing the negative perception about the sector within the banking community by carrying out training workshops for bank officials at all levels, which would increase awareness of the potential of lending to the sector and provide best practice techniques of doing so.
- Reviewing the restrictive collateral requirements and other regulations and procedures that reduced the flow of funds to the sector in order to make them more flexible to accommodate the needs of MSEs. Further, a study would be commissioned

on setting up a national credit guarantee corporation to alleviate the collateral problem for MSEs.

- External finance of the budget deficit by the government in order to increase availability of credit to the private sector and hopefully to the MSE sector.
- Setting up a venture capital fund to provide equity capital for MSEs.

### **2.3.3 *Non-financial promotional policies***

Non-financial promotional programmes (NFPP) include: guidance, counseling, marketing, product design, managerial and technical training, and other services provided to specific MSE enterprises and required for their entry, survival, productivity and growth. The policy framework for NFPP was aimed at overcoming the limitations faced in providing such programmes. These limitations were identified as lack of an enterprise culture, poor quality programmes that were also poorly coordinated, high cost of service provision, and lack of interest from the private sector, among others. The individual NFPP policies are discussed below.

#### **(i) Technical and managerial-enhancing policies**

- To increase the supply of entrepreneurs, universities and other training institutions were to introduce entrepreneurship education in their programmes. By reallocating more budgetary resources to training and encouraging cooperation between private sector providers of such training, the government intended to bridge the shortfall of trainers in such programmes.
- Market surveys carried out by the Ministry of Technical Training and applied Technology (MTTAT) were to be used to reduce the mismatch between the business skills required and the

training of entrepreneurs. Other measures to be carried out by the MTTAT were: training of entrepreneurs on choice of appropriate technology and popularizing self-employment and entrepreneurship through the mass media; establishing rural business centres targeting MSE and programme promotion; and developing curricula for apprenticeship courses with continuous opportunities accorded to graduates to attend refresher courses.

- To reduce costly duplication and encourage cooperation between the various organizations providing entrepreneurship education, an umbrella body was to be formed to coordinate the activities of the various organizations and public agencies involved in MSE development activities.
- Further, the cost-effectiveness of the programmes would be ensured by supplying these services to only those MSEs most likely to benefit; reducing the operational cost of the provisions of services; and encouraging cost-sharing between the providers and the beneficiaries.

(ii) Market-enhancing policies

To address the concerns of analysts such as Hunt (1983) who note that most non-farm activities in developing countries are demand-driven and lack the capacity to expand markets due to poor technologies, lack of innovative capabilities, low marketing skills, and lack of information about market structures, the government proposed a number of policies to enhance the markets for MSEs:

- The government undertook to conduct market surveys to identify new opportunities for product development and diversification in the MSE sector; identify new potential markets in the rural areas for MSEs; and establish a subcontracting

exchange through the Ministry of Industry to promote inter-industry linkages.

- MSEs were also to be assisted in penetrating export markets and their stringent demands on quality through training programmes designed to improve product design and product packaging; skills on production management, technology and material procurement, costing and pricing.

### **2.3.4 Gender-related policies**

The willingness of potential entrepreneurs to respond to profitable opportunities depends on the society's attitudes towards business. Certain social attitudes and practices reduce the effectiveness of women in business. In some societies for instance, women face cultural barriers in undertaking business activities outside the home. Even where women can carry out businesses, they often lack the needed collateral for acquisition of credit. The following policies were proposed to rectify the situation:

- Public education and use of women entrepreneurs as role models in order to reduce the negative attitude and practices towards women.
- Review of laws pertaining to land ownership and inheritance, and increased education of both men and women on the rights of women.
- Compilation of a database on women entrepreneurs by the Ministry of Planning in order to ascertain the level of women involvement in MSEs, including their successes and problems, and develop an appropriate support structure for them.

In sum, the Sessional Paper was the most comprehensive policy proposal on the sector until then. Unlike previous documents of its nature, it



was the result of a participatory process that included many stakeholders.

In Kenya's Seventh Development Plan (1994-1996), the government pledged continued support for the MSE sector through economic, financial and regulatory policies that would provide an enabling environment for sustainable growth and development, as articulated in the Sessional Paper No. 2 of 1992. More private sector involvement was to be encouraged through provision of a wide range of measures and incentives to improve the operations on MSEs such as access to credit and provision of appropriate technology and training.

Kenya's plans for industrialization by the year 2020, as documented in Sessional Paper No. 2 of 1997 on industrial transformation and in the 1997-2001 National Development Plan, are initially centred on the development of the MSE sector because of its labour-intensive production techniques and its use of locally available raw materials. In the Development Plan, the government proposes to increase collaboration between various government ministries, the private sector, NGOs and community-based organizations to:

- Review and develop the legal and regulatory environment for informal sector activities;
- Formulate and develop programmes to improve access to credit and finance;
- Support women and youth involvement in small/medium scale and informal sector through special programmes;
- Encourage strong backward linkages with the manufacturing sector;
- Review and harmonize licensing procedures for the informal sector enterprises;

- Develop programmes to assist MSEs and exporters improve product quality;
- Identify technology and workforce requirements for the sector and strengthen institutions that support *Jua Kali* technologies; and
- Encourage local authorities to set aside land for use as industrial parks specifically targeting MSEs so as to minimize the initial start up costs for investors.

Gender issues are again brought to focus in the 1997-2001 Development Plan and proposals are made for mainstreaming gender issues in industrialization. Donor and private sector support is to be sought to enhance capacity in National Women Organizations and related NGOs, and re-orient their activities towards industrial endeavours. The latter is particularly important given that Kenya hopes to industrialize in the next 20 years as noted in the Sessional Paper No. 2 of 1997.

The Sessional Paper No. 2 of 1997 also notes that if the Smallscale and *Jua Kali* Enterprises (SSJKE) are to grow as desired, constraints hindering their expansion and transformation to larger enterprises must be addressed. The identified constraints include access to credit, land, infrastructure, training and technical support, and access to technology and information. To ease the credit constraint, the government hoped to:

- Encourage the development of grassroots financing systems;
- Encourage expansion of more formal sources of credit through specialist agencies such as K-REP, PRIDE, etc;
- Encourage adoption of less stringent capital-based collateral lending by formal banks; and
- Continue supporting NGOs that provide credit to SSJKEs.

To solve the problem of access to land and infrastructure, the government planned to:

- Identify suitable, commercially viable sites that can be let, leased or allocated in block to informal enterprises as appropriate; and
- Provide infrastructure in terms of roads, water and power;

To enhance training and technical support, the government planned to:

- Enhance the role of the Ministry of Research, Technical Training and Technology in providing effective training, coordination and innovation.

To improve access to technology and information, the government hoped to:

- Put in place a well-defined means of transferring technology and information to the entrepreneurs;
- Support extension services of the research and development (R&D) institutions like KIRDI and local universities; and
- Develop the Technology Development Grants System as elaborated in the Micro and Small Enterprise Training and Technology Project so as to link research and technology institutions with the *Jua Kali* enterprises.

Noting that MSEs are a “seedbed” for both product and managerial development, the paper proposes the following to promote further development:

- MSE products are to be given priority in the Central Tender Board and other procurement agencies;
- The government is to promote cooperation and inter-linkages through the organization of “seller-meets-buyer” initiatives; and

- The FKE initiative in offering management training and counseling to SSJKEs will be extended and the assistance of individual firms sought.

The Sessional Paper also proposes removal or amendment of licensing and other regulations hindering the development of MSEs. The Vagrancy Act, for example, is subject to arbitrariness and may unnecessarily hamper the activities of MSE activities. The General Nuisance bylaw of the City of Nairobi also extends to cover a wide range of activities of the MSE sector. The Sessional Paper proposes their review and not removal.

Finally, the potential of the sector as a main pillar of industrialization is noted and the government promises to:

- Provide all the necessary assistance to the sector while keeping in mind that an overly interventionist policy can threaten the very strengths that creates prosperity; and
- Promote mechanisms that create full dialogue between the government and the private sector in order to establish a balance between positive support and negative intrusion.

From the foregoing, it is clear that the government has over time increased its policy focus on the MSE sector and therefore the ability of the sector to create jobs and generate income. Whether the sector has lived up to its expectations can only be judged by assessment of the performance of the sector.

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## 3. Micro and Small Enterprises in Kenya

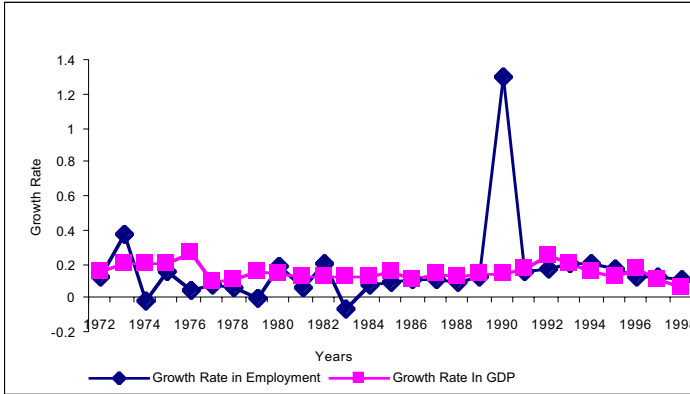
### 3.1 Overview of MSEs in Kenya

As in many developing countries, there is a dearth of statistics on the MSE sector in Kenya. Other than employment statistics on the sector, no other time series statistics exist that can capture the evolution of the sector. The time series employment statistics have an interesting story to tell about the relationship between employment in the MSE sector and overall performance of GDP. The figure below shows that growth in employment in MSEs closely tracks growth in GDP. This finding is important because GDP statistics has in the past mainly captured economic activity in the formal sector leaving the informal sector activity.

Mead (1998) observed similar trends in growth of the economy and the MSE sector. He noted that the health of the economy as a whole has a strong relationship with the health and nature of small and micro enterprises sector “for in good times, a relatively high share of the new small and micro enterprise jobs are closer to the growth end of the spectrum. When the state of the macro economy is less favourable, by contrast, the opportunities for profitable employment expansion in MSEs are limited. In such circumstances, a larger proportion of [such employment] which would be closer to the survivalist end of the spectrum.” Therefore, an understanding of the dynamics of MSEs is necessary not only for the development of support programmes for small and micro enterprises, but also for the growth of the economy as a whole.

The trend shown in the figure below may imply that policies that boost the formal sector activity would also boost the informal sector performance through trickle down. However, this interpretation should be made with caution since the available data on the informal sector activity may not be comprehensive, and therefore the need for an

empirical analysis. The sudden rise in growth rate for employment in MSEs in 1991 can be associated with increased recording of the sector's activities.



It has been argued that the dynamics of small enterprise development can best be understood by carrying out longitudinal studies that seek to monitor the condition of individual MSEs or the small enterprise economy over a period of time. Such research examines the problems of enterprises at different phases in their development cycle from start-up, through growth or survival and up to potential graduation or closure. The information generated by such research is especially valuable for policy makers in facilitating the construction of an appropriate mix of support interventions for the sector.

This section draws from a recent research survey on the sector, the 1999 National Baseline Survey conducted by CBS, ICEG and K-REP holdings, which provides the most recent comprehensive picture of MSEs in Kenya. Using stratified sampling procedures covering the entire country, all non-farm enterprises employing 50 workers or less were enumerated.

The main findings indicated that there were 1.3 million MSEs in Kenya, employing an estimated 2.4 million people. Over 99 percent of the firms employed only one-person. The average income of the enterprises

surveyed was about 2.5 times higher than the minimum legal wage for general labourers. The share of contribution of the MSE sector to GDP was estimated at 18.4 percent. Trade activities account for 64.1 percent of the activities of MSEs in Kenya. Two thirds of the enterprises are located in rural areas but with higher densities in Nairobi and Mombasa. Gender variation in ownership is not very big although sex segregations occur by trade.

More than 50 percent of the entrepreneurs had at least primary level of education but only a few (15 percent) have had management training, technical training or market counseling. Inter-firm linkages were found to be very weak. By comparing results of earlier baseline surveys (1993, 1995), the study showed that the sector had experienced little growth in firm size. There is a high degree of informality within the sector with more than 88 percent and about 61 percent of the firms operating without registration or any license, respectively.

In terms of operational constraints, the survey found that access to markets, followed by lack of capital, were the main constraints facing MSEs. Other constraints include: inadequate business support services; poor roads; shortage of raw materials; interference by authorities; poor security; lack of a work site; lack of personnel; and power interruptions.

The findings of the study suggest that Kenya is not deficient in entrepreneurs given the large number of enterprises (1.3 million). However, the majority of enterprises are one-person establishments. Evidence from African studies suggest that these kinds of businesses are the least effective and least remunerative of small enterprises (Arnold *et al.*, 1994; Mead, 1994 and 1998).

An understanding of the factors that cause some firms to grow and become successful small enterprises, creating sustainable or long-term employment opportunities is critical for policy making. Evidence suggests that when small enterprises expand, even by adding one or

two workers, this growth is associated with increases in economic efficiency (Arnold, *et al.*, 1994). The next section analyses the nature of some of the impediments that may have hindered growth of the MSE sector in Kenya as it was envisaged in the Sessional Paper No. 2 and other policy pronouncements. Some of these impediments were also identified in Mullei and Bokea (2000). The existence of the constraints, apart from stifling growth of MSEs, also hinders their participation in the global markets.

### **3.2 Constraints to the Growth of MSEs**

The constraints to the growth of the MSE sector in Kenya can be classified as those external to MSEs and mainly affect demand for MSE products, and those that are internal and impede the supply of such products. The domestic policy environment is the main external impediment to the growth of MSEs in Kenya. Domestic policy environment can in turn be divided into: the macroeconomic environment, incentive policies, and institutions. The combination of macroeconomic instability, distorted incentives and weak institutions tends to create a difficult external environment for MSEs.

Constraints internal to the MSEs (also identified in earlier policies) include limited access to finance, low management skills, poor infrastructure, limited access to markets and market information, low technological skills and adoption, as well as some gender issues.

#### **3.2.1 External constraints**

##### ***Macroeconomic environment***

Although the move towards economic liberalization proposed in the late 1980s and 1990s was aimed at reducing distortions in the economy, deregulation of markets has had adverse impact on MSEs. The effects include increased macroeconomic instability characterized by high



inflation rate, current account deficits and policy uncertainty. While the effects have been harmful to all private enterprises, the MSEs have been particularly hurt given their small size, and because they have fewer options to ride over instabilities.

### *Incentive policies*

Trade policy is the most important incentive policy because it provides the link to a market for MSE outputs, and a source of inputs and opportunities to produce within an international production chain. Since the adoption of an open trade policy in Kenya, MSEs have increasingly been involved in the global market. Imports have increased rapidly and this has meant greater competition for their goods in the local market. Trade liberalization has increased competition at home and this is seen as detrimental to MSEs in Kenya, especially those in textile industries. Similar observations were made in Latin America and Canada (Berry, 1996). The indication for Kenya may be that although general incentive reforms are necessary, they may not be sufficient to foster the growth of MSEs.

Experiences of the more successful industrial performers among developing countries suggest that government interventions, despite their dismal record in many countries, play a vital role if carefully designed and well implemented. Incentives geared to promoting competitiveness in world markets, but providing some protection for “infant industries” and building up indigenous capabilities, seem to be the most effective combination. Capabilities should be developed through education, training, technological effort and diffusion in which governments and donors have a role to play because many skill and information markets suffer from market failure. Successful experiences in East Asia suggest that it is important that institutions develop to enable markets to function; markets left alone may not generate the right institutions.

### ***Institutional policies***

An unhealthy incentive environment may exist in form of regulations. Regulatory policies may discourage increases in size of operation for firms, even though there may be opportunities to exploit economies of scale<sup>6</sup>. But the cost of registering business<sup>7</sup>, the need to use external accountants to satisfy regulatory requirements, and the time spent dealing with disputes with regulatory agencies can be more expensive per unit of production for MSEs. The informal entrepreneurs in MSEs have frequently borne high costs in the form of harassment for non-compliance, and often run the risk of permanently being put out of business.

The tendency of micro and smallscale operators, especially small sellers and producers, to congregate in the dense markets and overcrowded cities makes them prey to city authorities in the effort to clear congestion and pollution. Policies that provide a central location where micro enterprises can share facilities are totally lacking in Kenya. Such policies should entail developing a programme of orderly urban development that accommodates the needs of micro enterprises and discourages dispersal to remote areas, as this will retard the growth of MSEs.

Institutions are the foundation of property rights. As such, they must give confidence to firms to write contracts and also allow legal recourse to be cost effective so that contracts can be enforced. Institutions provide good protection from arbitrary rules of governments and reduce

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<sup>6</sup> Abuodha and Bowles (2000), in their assessment on the impacts of licensing reform for business in Kenya, observed that smaller enterprises find regulation and taxation more burdensome than larger firms.

<sup>7</sup> Prior to the license reforms in 2000, a firm needed 15 licenses a year that costs about one month in processing time. For larger firms, there were 49 licenses, taking about three months (World Bank Private Sector Strategy Paper, 1992). Time and cost of registering business ranged from just about two months to slightly over three months in Brazil and about four and half months in Peru for garment industries (Stone *et al.*, 1992; Stone, 1993).

uncertainty. Unfortunately for Kenyan MSEs, there are indications of instability of property rights, which undermines the effectiveness of contracts. In their study on evaluation of the mechanisms for creating property rights for informal firms in Nairobi, Kimenyi *et al.* (1999) showed that the vulnerability of the informal sector property rights to revocation makes law a critical threat and veto point that could be used by extortionist officials to levy taxes on informal enterprises. All these unfavorable features of the external environment for businesses must be addressed because very little success can be achieved through general promotion of MSEs.

### **3.2.2 *Internal constraints***

#### ***Lack of access to capital***

Many surveys of MSEs show that lack of capital is a strong constraint to growth (National Baseline Surveys, 1993; 1995; 1999; Stone, *et al.*, 1992). Most MSEs rely mainly on own savings and reinvested profits to finance their business. Comparison of results of the three baseline studies of 1993, 1995 and 1999 show minor improvements in the situation—from 9 percent of MSEs accessing credit in 1993 to 10.8 percent in 1999. Formal credit increased from 4 percent to 5.7 percent, a reflection of a rise in the number of NGOs focusing their support on MSEs. The number of NGOs increased from 46 to 130 between 1995 and 1999 (Oketch, 2000). Many of these NGOs however, have limited financial resources and few have systems and organizational structure to support large MSEs. In 1995, the Kenya Rural Enterprise Programme (K-REP) realized that as an NGO, it lacked capacity to serve as an effective financial intermediary and decided to establish a micro-finance bank in 1999.

Formal financial institutions perceive the high risks and transaction costs as impediments to lending to the MSE sector. In addition to the limited capacity of banks to lend to MSEs, there is the difficulty of enforcing contracts due to an inadequate legal framework and inefficient court

systems. The banking laws and regulations do not currently differentiate the market segments served by micro-finance institutions. There is need to review the regulations in order to reflect innovations in financing MSEs.

Where formal banks have lent to the MSE sector, they have simply acted as a conduit for funds externally sourced from donors and guaranteed by the government. The fact that there has been no significant lending from the banks' own initiative is an indication of a weakness in policy. The banks continued lack of interest and the subsequent reluctance of the Central Bank to relax the lending requirements to the MSE sector might reflect inadequate consultations between stakeholders. However, there has been a change in attitude towards the MSE sector which has been achieved through courses offered by the College of Banking, although the existing culture in the financial sector makes it difficult to apply what is taught (Oketch, 2000). Furthermore, very few banks have sent their staff for the training, an indication that the banks do not find the sector viable. The enactment of the Micro-finance Bill is hoped to ease the regulatory and other financial risks that currently constrain lending to the sector.

But as much as Kenyan entrepreneurs may cite lack of credit as the most constraining factor to business operations and contributing to 37 percent of business closures (National Baseline Survey, 1999), lack of capital can be a secondary rather than a primary problem. Rukunga (1999) indicates that most MSEs do not keep proper records and most entrepreneurs do not pay themselves a salary. Instead, they make withdrawals as need arises. Such withdrawals may exceed earned income, therefore eating into the working capital. This is a problem of poor management skills.

### *Low management skills*

The ability of entrepreneurs to combine resources effectively depends on educational policies that emphasize practical business skills. Education has been observed to be one of the factors that impacts positively on growth of firms (King and McGrath, 1998). Those entrepreneurs with larger stocks of human capital, in terms of education and/or vocational training, are better able to adapt their enterprises to constantly changing business environments (King and McGrath, 1998). Kinyanjui (1996) also highlighted the need for education in businesses when she distinguished two types of entrepreneurs in Kenya: the 'plodders' running undynamic firms, and those having dynamic firms. The difference between the two firms is in the level of educational qualification attained by the entrepreneur. The 1999 Baseline Survey also showed incomes of enterprises to differ with levels of education, being highest for postgraduate group and lowest for those with no education.

There are several institutions in Kenya, both private and public, providing technical training. The institutions have been established with a strong vocational bias and with the objective of self-employment. There are three national polytechnics, 17 institutes of technology, 20 technical training institutes, over 600 youth polytechnics, the National Youth Service, Christian Industrial Training Centres, YMCA Vocational Training Centres and three Industrial Training Centres.

Despite the many institutions, only a handful (1.5 percent) of entrepreneurs reported having received any form of training (National Baseline, 1999). This formal training in the formal sector is compared with that in the informal sector. According to a World Bank study (1991) 40 percent of all trainees acquire their skills through apprenticeship.

Apprenticeship involves on-the-job-training in the business set-up and has been found to be very efficient in terms of employment and cost

since most of those trained are absorbed in the sector and also contribute to the cost of the training (McCormick, 1996). However, this kind of training is limited by low exposure to technology because the trainee can only learn using the available tools, by the ability of the artisan to impart the knowledge, and also by the time the artisan usually has to impart the knowledge and skills.

Also important to skill development is the education system's ability to impart skills to the trainees. The 8-4-4 system of education has, to some extent, been able to change the attitude of the youth towards self-employment. However, the extent to which the system has been able to impart skills as envisaged at the introduction of the system is still questionable. King (1996) observes that it is difficult to examine pupils on some of the practical subjects due to differences in school endowments.

There is a lot of debate on the ability of the 8-4-4 curriculum to impart cognitive and attitudinal skills for later work. The World Bank policy advice is against vocationalization of primary and secondary education. The Bank feels that "diversified" programmes are no more effective than academic secondary education in enabling graduates to enter wage or self-employment (World Bank, 1991). The general position of the Bank is that because the social returns to vocational education are much lower than those to general secondary education, vocational and technical education is best delayed as long as possible, ideally confined to the workplace, and best preceded by general education (World Bank, 1995).

### ***Poor infrastructure***

Infrastructure as it relates to provision of access roads, adequate power, water, sewage and telecommunication has been a major constraint in the development of MSEs (Bokea, Dondo and Mutiso, 2000). The public sector has failed to provide a good infrastructure framework which is essential for the growth and development of a competitive private sector.

Although several politically inspired attempts have been made to provide good infrastructure, mainly worksheds, for MSEs this is not often included in town planning. Access roads to MSE sites are in poor shape and this has meant higher costs of doing business. Though Sessional Paper No. 1 of 1986 promised expansion of electricity supply and water for all by the year 2000, the situation is far from what was envisaged. Frequent power rationing and water shortages experienced in the late 90s have made it difficult for industries, especially those in manufacturing and service sectors. Lack of access to electricity has hindered technological growth for MSEs given that most modern processes are electrical. The high cost of electricity (including high connection charges) has also been a hindrance to access to power. There is also lack of a clear policy for enhancing power supply to MSEs.

Availability of reliable water supply makes compliance with health and environmental requirements easier. In terms of environmental conservation, small enterprises are a hazard given that over 60 percent do not have water in their premises and use open spaces, rivers and streams to dispose their waste and effluent. About 78 percent of small enterprises rely on burning or dumping for waste disposal. The infrastructure needs of these MSEs need to be addressed in order to mitigate on this negative aspect and to increase environmental awareness among MSEs. However, although MSEs may face financial limitations in adopting pollution control systems, they need to be encouraged to adopt cleaner methods of production and exhibit respect for environment safety.

### *Accessibility to markets and market information*

Access to markets and lack of market information is one of the most critical constraints to the growth of emerging MSEs in Kenya. The prescribed policies for addressing this problem do not seem to have achieved much success because access to market and information on

competitors continues to be a severe problem for MSEs (as cited by 34 percent of those interviewed in the 1999 National Baseline Survey). Due to the depressed state of economic activity in Kenya, markets have been characterized by limited purchasing power of the average consumer. A wide range of consumer goods competes for the buyer's money and preference is often oriented to the cheapest product. In turn, the enterprises compete in a market that views domestic products as vastly inferior to foreign-made products. Since the release of Sessional Paper No. 2, MSEs have had to contend with shifts from import controls to import liberalization and this has intensified competition leading to closure of many enterprises.

Several initiatives have been made to promote the sector through trade fairs and provision of workspace and marketing strategies. In recent times, there has been some support from the private sector, especially from among others the Coca-Cola Company, British American Tobacco (BAT) and the Asian Foundation. Although some of this support may have been more of a company strategy to boost sales through informalization of the formal sector rather than a response to the laid out policies, it has nevertheless assisted in developing marketing outlets for MSEs. These tie-ins are the kind of subcontracting envisaged in the more recent policy documents and can go a long way in solving the information problem prevalent in the MSE sector.

Tie-ins with foreign firms would reduce the need for direct efforts to acquire market information and provide a low cost-alternative to going it alone. Therefore, a policy environment that encourages foreign direct investments is an important strategy for acquiring market information and also technology and management skills.

The need for links between firms becomes even bigger if small firms are to exploit export markets. From January 2001 for example, Kenya was supposed to start exporting goods to the US duty-free under the



African Growth and Opportunity Act (AGOA) arrangement. The lack of capacity in domestic firms to meet their export quotas may require them to subcontract to MSEs to avoid losing their orders. This is especially so with regard to garment exports. Given that the US market has an ingrained culture of litigation and compensatory arrangements, Kenyan firms must walk a tight rope to meet the finest details of the contracts. The fact that a single chain could demand millions of units means that Kenyan firms might have to pool resources to meet such demand.

The initiative of the Asian Foundation was in the form of establishing worksites for MSEs. The Foundation set up two markets for hawkers in Nairobi (City Park and Kibera) complete with sheds, water and sanitation. However, the problem of the fragile land rights of the informal sector still dogs the markets such that although the Foundation would like to put up more facilities, unavailability of land is a constraint. Policies should be put in place to facilitate land ownership for such groups who have shown capacity to promote the MSE sector.

#### ***Low technological skills and adoption***

Industrial technology in Kenya is yet to take off and most MSEs have not even achieved the first level of industrial take-off (Aduda and Kaane, 2000). This first level entails encouraging enterprises manufacturing consumer goods to acquire the latest technologies that are efficient in use of materials and utilities in addition to being more environmental friendly.

The challenge facing MSEs in developing countries, Kenya included, is how to move from the relatively informal cottage industries to larger enterprises with stronger technological capacities and performance. Innovation potential exists in many small enterprises but has not been tapped to raise incomes for the small entrepreneurs. Little funding has gone into identifying, documenting, follow-up and financial support

for technological change and innovation in MSEs (Mihyo, 1994). There are serious shortcomings in technology management and there are no systems for promoting good innovations and information exchange among MSEs and other stakeholders in the sector (Aduda and Kaane, 2000). One way of achieving this is through inter-firm linkages.

Although larger enterprise size may seem desirable, the global trend in industrial structure is towards small-sized enterprises (Meyanathan and Munter, 1994). Inter-firm linkages are therefore paramount if Kenyan firms are to benefit from increased decentralization and downsizing in the global arena. The policy imperative is therefore to create environments and incentives for the formation of industrial structures rich in linkages among MSEs, for example formation of clusters, and between MSEs and large enterprises.

#### *Gender issues relating to MSEs*

Some gender issues are important for the success of MSEs. Women, for instance, have different goals and employ different strategies to those of male entrepreneurs. The goal of women is mainly to feed and educate their children (Downing, 1991) while men generally undertake business risks in pursuit of profits. Conflicts arising from the different roles women have to play in households, including the “long” time spent at the enterprise site, have been cited as constituting a major obstacle to the stability and growth of women-owned enterprises and their development in Kenya (Kinyanjui and Munguti, 2000). In a similar note, the 1999 National Baseline Survey notes that a third of women entrepreneurs cited personal reasons as one of the key causes of business closures. Most of these personal reasons were related to family responsibilities. Only a fifth of men cited personal reasons as a cause of business closure.

Although significant progress has been made in eliminating negative social-cultural attitudes towards women through gender sensitization,

disparities still persist in enrollment and retention rates in secondary and tertiary education. Low levels of education may in turn lead to inadequate access to and control of economic resources. Furthermore, social norms are still characterized by cultural practices that accord lower status to women and perpetuate the dominance of men in access and control of property and other resources within families. Decision-making has mainly remained the prerogative of men and the household authority model is such that the wife has to ask for permission from the husband before undertaking any economic venture. The 1999 National Baseline Survey showed that even where women manage the business, the man controls the finances. This has consequences in terms of availability of credit to women. The gender differences in society have permeated the credit market to favour the male entrepreneur. The lack of credit for women has been associated with lack of collateral and sometimes a negative attitude that perceives women as uncreditworthy. To address this gender imbalance, credit schemes such as the Kenya Women Finance Trust (KWFT) have been established to target women entrepreneurs.

Although training is a necessary ingredient in entrepreneurial development, this was found to be lacking for both men and women in MSEs (National Baseline Survey, 1999). Because women are limited in accessing training due to their reproductive roles, emphasis should be more on making training convenient by, for example, locating the training nearer to entrepreneurs.

## **4. Critique of the MSE Policies**

From the foregoing, it is clear that a clear follow-up and evaluation mechanism in the MSE sector is still lacking despite the recent efforts by the government to improve policy formulation in the sector. To facilitate proper implementation, policy documents should have clear lines of responsibility, accountability and ultimate answerability for the policies outlined. The effect of the absence of these is exemplified by the registration of *Jua Kali* associations where registration of a large number of new societies across Kenya led to some competition among different government agencies and departments (King, 1995). In addition to stating the responsibilities for various organs, it would be necessary to assess the capabilities of such organs before they are expected to account for results. Though such assessments have a cost, it may be cheaper in the long run than the time lost in the implementation process.

Prior to 1992, the process of policy formulation in the MSE sector was generally top-down. Interventions were made according to what the government thought was best for the sector. For such policies to be effectively implemented, force is often required from the top. Further, such policies may be operationalised to achieve particular political goals. However, to increase commitment of subordinate organs in policy implementation, policy formulation needs to increasingly be a participatory process. The failure of policy initiatives in technology development for the Rural Industrial Development Centres, for example, may partly be blamed on the top-down approach that was used. Instead of the innovative activities being based upon or drawing from the initiatives of the artisans, technologies were designed and then popularized among rural artisans.

But even in 1992 where a stakeholder process resulted in the Sessional Paper, the policy framework failed to recognize the heterogeneity of

the sector. No separate interventions were made to cover the separate segments—that is the survivalist and the growth-oriented segments—yet their needs are clearly different. This means that in many cases, failure to implement simply compounded what was already a failure at the policy design stage. Even if implementation were to take place, desired results of growth and income generation would not possibly have been achieved.

Most of the policy prescriptions have failed to note the conflicting effect policies may have on target groups. The conflicting effects an improved infrastructure can have on small enterprises especially in the rural areas should, for example, be noted in an infrastructure development policy. Such policies can either increase or decrease support for small enterprises. On the one hand, it may raise low incomes, and therefore demand, while lowering the cost of production. High transport costs protect local markets from imports while the absence of utilities discourages entry by larger firms. Foot-loose small producers can blossom in these markets, and competition among them may suffice to make them more efficient. Improved transport and electricity may help small firms by boosting agricultural incomes and lowering their costs but will also expose them to greater competition from imports. While increased competition is desirable in the long run, initial protection may be necessary for small firms.

Policy prescriptions have also been made without consideration of the cost involved in each prescription. Consequently, there has been little implementation. Implementation has occurred to a high degree only where there has been external funding. Despite the government committing itself to ease business-licensing procedures (as evidenced in various national development plans and budget speeches since 1996), it was not until the British Department for International Development (DfID) came in (through the Deregulation Programme) that implementation of trade licensing reforms began. Similarly, in provision

of credit for MSEs, banks have only considered the sector when the funds for on-lending have been sourced externally. Banks have not been very eager to screen the borrowers and this may explain the high failure rates of the programmes due to defaults. None of the loan guarantee funds established with commercial banks since 1977 are active today (Oketch, 2000).

Implementation of the 8-4-4 system of education, though a local initiative, also showed lack of cost consideration in policy formulation. The intent of the system was that practical subjects would be examined for both their theoretical and practical content. However, due to disparity in tools, equipment and workshop space, it has been difficult to carry out national examinations for practical subjects.

The cost of implementing policy notwithstanding, there seems to be lack of political will in implementing policies targeting the MSE sector. Other than those policies with external support, most of the policies in the MSE sector have had a low degree of implementation; those that had a high level of implementation also had great support from the government.

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## 5. Conclusion and Recommendations

From the review of the policy framework, it is observed that government policy on the MSE sector was only formulated in the latter half of the 1980's despite having frequent, albeit, disjointed policy statements on the sector as far back as 1972.

Despite increased ownership of MSE policy in the 1990's, there has been little policy implementation. One of the drawbacks in policy implementation has been the failure of the government to consider policy on MSE as part and parcel of a broad economic policy framework, encompassing macroeconomic policies. Consequently, there has been very little growth in the MSE sector.

The various impediments, policy or otherwise, that constrain the growth of MSEs include:

- (i) The domestic policy environment encompassing the macroeconomic environment, incentive policies, and institutions. A combination of these impediments tends to create a difficult external environment for MSEs.
- (ii) Internal constraints that tend to constrain supply of goods and services from the MSE sector. They include limited access to finance, low management skills, poor infrastructure, limited access to markets and market information, low technological skills and adoption, and also some gender aspects.

These constraints have resulted in loss of competitiveness for MSEs. To increase competitiveness, the paper proposes intervention by the government and support partners in developing the capabilities of the MSE sector through education, training and technological effort.

To facilitate access to financial services, worksites and inter-firm linkages, a legal framework that ensures contract enforcement should be put in place. Formal banks with little experience on lending to the

poor should be encouraged to develop linkages with informal lenders. Such links would unlock formal sector resources for use in micro enterprises but mechanisms that reduce risks to banks should be developed. Further, a regulatory framework that encourages innovative financial products that cater for the sector in addition to formalizing lending to the sector should also be put in place.

To ensure safer worksites, policies that provide a central location where MSEs can share facilities with other sectors should be developed.

To ascertain proper implementation of MSE policies and subsequent growth of the firms in the sector, the paper further recommends that:

- (i) MSEs are perceived as part and parcel of the economy, affecting and in turn being affected by macroeconomic factors.
- (ii) The policy framework for the MSE sector should include a clear coordination mechanism of all the implementing agencies. The policies should have clear lines of responsibility, accountability and ultimate answerability.
- (iii) Policy pronouncements on the MSE sector should accompany resource allocation and assessment of human resource capabilities.
- (iv) Policy design for the MSE sector should consider the heterogeneity of the sector and conflicting impacts on target groups.

In order to increase understanding of the sector and therefore enhance the development of a better policy mix for the sector, the paper proposes comprehensive studies on factors that contribute to growth of firms. Because of the importance of education, training and technology in success of enterprises, research on the education-enterprise initiatives in Kenya is singled out. This should include an assessment of the education system in Kenya in terms of its cost-effectiveness in preparing



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children for work. The assessment of post-school experience is deemed urgent especially in the 8-4-4 system of education since it is apparent that the system is undergoing reform. Knowledge of any particular deposit of skills and attitudes from different reform phases in education and training systems should be built upon in order to ensure coherence in policy for enterprise development.

Finally, efforts towards promotion of the MSE sector and poverty reduction should go hand in hand with other policies of raising the incomes of the rural population. Raising rural incomes is essential to stimulating demand for off-farm employment. This implies improvement of agricultural prices, increasing farmers' access to credit and input, providing marketing services, and investing in rural infrastructure. It also means that providers of business development services would have to increasingly adjust their supply to rural-based MSEs. Although the cost of such interventions may be high, sustained growth of the sector can only be achieved by creating conditions that increase the productivity of the rural areas.

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