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KENYA ECONOMIC AND POLITICAL TRANSITION PROJECT FOR ECONOMIC RECOVERY

Economic Growth Scenarios for Employment Creation in Kenya

Introduction

Employment creation in Kenya is a major concern to the government. The 1998/99 Labour Force Survey estimates Kenya's active labour force at 10.5 million people, and unemployment at 14.6% of the active labour force. Given the weak economic performance between year 2000 and 2003, there is no doubt that the situation has deteriorated. Among the employed, the number of the working poor is high, comprising primarily of subsistence farmers, female-headed households and pastoralists. Underemployment is also a common phenomenon in the public sector. Faced with this problem, and in the middle of a worsening poverty situation, the overriding challenge for the country is to create employment for the growing labour force.

This policy brief is based on a technical paper on growth scenarios developed under a study on *Economic growth scenarios for employment creation in Kenya*. The study explores different policy options that the Government can pursue to generate 500,000 new jobs annually. The scenarios have been developed using the KIPPRA-Treasury Macro Model (KTMM), a macro-model of the Kenyan economy. The model is used to provide medium term projections of major macroeconomic variables in a consistent framework. The brief also draws from other KIPPRA research on the *Exchange rate and interest rate differential in Kenya: a monetary and fiscal policy dilemma*; *Kenya's exchange rate movement in a liberalized environment*; *Analysis of Kenya's export performance*; and on *Estimation procedure and estimated results of the KTMM*.

The current Government, which took power at the end of the year 2002, pledged to create at least 500,000 new jobs every year. This position has been adopted as the official Government policy with respect to employment

Table 1: Growth in employment by sector

Sector	1981-1985	1981-1990	1991-1996	1997-2001	2002-2003
Private sector	2.35	3.42	4.55	2.11	2.42
Public sector	4.04	4.04	0.26	-1.22	0.05
Self employment	-8.90	7.90	4.11	0.69	0.23
Informal sector	16.06	11.41	20.93	11.83	9.51
Total	**4.21**	**5.32**	**11.98**	**8.04**	**7.36**

Source: Economic Surveys (various)

creation. It is depicted in the *Economic Recovery Strategy for Wealth and Employment Creation 2003-2007* as a key medium term macroeconomic objective. The informal sector is expected to play a key role in expanding employment opportunities. A total of 2,636,130 jobs are expected to be created over the period 2003-2007, out of which 12 percent will be from the formal sector and the balance of 88 percent from small business enterprises.

Growth in employment within the public sector has declined due to reforms that have included privatisation, divestiture, ministerial rationalisation and retrenchment aimed at reducing the size of the public sector. Employment growth in the formal private sector employment has been sluggish, while employment in the informal sector has in the past grown at rates above 10 percent, except in the period 2002-2003 (*Table 1*). The key challenge to the Government is to reverse the declining employment rates and create the promised 500,000 new jobs annually.

Exports, Investment, Growth and Employment

Kenya's growth experience provides important lessons for designing measures for employment creation. First, high economic growth is a necessary condition for employment creation and poverty reduction. In 1985-1989, Kenya experienced a high economic growth rate of 6 percent. The same period is also characterized by a marked increase in formal employment creation. Second, poor economic performance is associated with a shift in employment pattern from the formal to informal sector. Third, high levels of private investment and export growth are necessary for attaining rapid economic growth and employment creation. The high economic growth in 1985-1989 was supported by high private investment and expansion in exports. Economic performance has been weak during periods of depressed private investment and exports.

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Besides these lessons, a conducive macroeconomic environment is also required for the creation of 500,000 new jobs annually. Over the years, the government has progressively tightened its fiscal stance from the period when the budget deficit averaged 5.4 percent of GDP (1985-89) to the period when it averaged 0.6 percent of GDP (1997-2001). This deceleration was exacerbated by a weak expenditure structure that favoured consumption as opposed to investment. The associated reduction in public investment partly explains the dismal performance in private investment. In short, an important lesson from the past is that a tight fiscal policy should go hand in hand with the requisite fiscal discipline and improved allocative efficiency.

Monetary policy can fulfil its objective in facilitating non-inflationary economic growth and employment creation. However, monetary policy has to be supported by a competitive banking sector to enhance the efficiency of the transmission channel.

Following reforms in early 1990's, Kenya's foreign exchange rate is liberalized. The market determines the exchange rate, and interventions by the Central Bank of Kenya are limited to addressing instabilities not related to market fundamentals. A stable market-determined exchange rate that reflects Kenya's competitiveness is favourable.

Growth Scenarios

Four policy options for spurring economic growth and creating employment are considered: First, is the investment-led growth option, which considers the private sector as the engine for economic growth. Second, is the export-led option, which explores expansion in exports as the key to economic growth and employment creation. The third and fourth policy options focus on the public sector as the engine of economic growth in the short run through fiscal stimuli involving retiring domestic debt (so as to reduce fiscal pressure on the economy and lower the burden of domestic debt repayment) and increasing public investment, respectively.

Investment-led growth

Domestic and foreign investments have declined in the recent past. High interest rates, poor infrastructure, low investor confidence due to governance issues, lack of external funding, insecurity and uncertainty are some of the factors that have contributed to decline in investment. The scenario for the investment-led strategy is based on the assumptions of designing policies to lower long-term interest rates by three percentage points, and increasing public investment (which should be externally-financed) by Kshs 5.7 billion. It also assumes reduction of corporate tax from 30 to 25 percent. Improved political and economic climate following deepening of reforms, and realization of the above targets will make it possible for the country to attract more foreign investment. Besides, improved infrastructure and governance reforms will enhance productivity. It is therefore assumed that Kenya will be able to attract capital inflow of Kshs 3 billion in form of Foreign Direct Investment and that productivity would increase by about 0.5 percent.

Export-led growth

The Poverty Reduction Strategy Paper (PRSP) envisaged an export-led growth as the strategy to help Kenya attain the status of a 'newly industrialized country' by the year 2020. Besides, it is evident that growth in export earnings is necessary for sustained economic growth and employment creation. In this regard, export expansion is one of the key policy options for attaining higher levels of economic growth and employment. Under the export-led strategy, a macroeconomic policy simulation scenario is built with the following key assumptions:

- Increasing competitiveness in key export sectors such as coffee, tea, horticulture and tourism through improved infrastructure, which would reduce the relative cost of production within the export sector by about 3 percent.
- Increasing export earnings through intensive marketing abroad of products and services (for example tourism), improving security in general and in parks, offering high quality products (for example processing before exporting), better packaging, and better services. It is assumed that such measures can generate additional export earnings of about Kshs 17 billion especially through tourism and the African Growth and Opportunity Act (AGOA) initiative.
- The increase in exports may require additional investments, in for example semi-processing and manufacturing industries. With the AGOA initiative, for instance, investments in the textile industry are likely to increase. An additional investment of Kshs 3 billion is assumed.
- Like in the investment scenario, it is assumed that Kenya will remain on programme with the

Table 2: Key economic indicators (deviations from base)

	2004	2005	2006	2007
Investment-led Strategy				
Real GDP growth (% change)	0.6	1.7	2.8	2.7
Private investments (% change)	2.6	7.6	8.4	5.2
Exports (Goods and services % change)	0.3	-0.3	3.8	3.9
Wage employment (Business % change)	-0.2	0.5	1.2	1.5
Total wage employment (millions)	-0.002	0.004	0.021	0.043
Export-led Strategy				
Real GDP growth (% change)	2.6	1.7	2.2	1.6
Private investments (% change)	3.2	5.9	4.7	2.9
Exports (Good and services % change)	8.6	0.1	3.6	2.5
Wage employment (Business % change)	0.4	0.8	1.2	0.7
Total wage employment (millions)	0.005	0.015	0.032	0.043
Debt Externalization Strategy				
Real GDP growth (% change)	0.8	3.3	3.3	2.3
Private investments (% change)	5.8	8.9	10.1	1.8
Exports (Goods and services % change)	-7.2	1.6	4.5	7.0
Wage employment (Business % change)	0.1	0.9	1.7	1.6
Total wage employment (millions)	0.001	0.013	0.036	0.060
Heavy Public Investment Strategy				
Real GDP growth (% change)	1.4	4.1	4.2	1.3
Private investments (% change)	6.4	11.5	11.8	1.0
Exports (Goods and services % change)	-7.1	2.3	6.0	7.8
Wage employment (Business % change)	0.3	1.3	2.2	1.5
Total wage employment (millions)	0.004	0.020	0.051	0.076

IMF and other development partners, and would be able to access about Kshs 5.7 billion for public investment either as grants or concessional loans. In addition, the reforms being undertaken would increase productivity.

Debt retirement and public works investment programmes

The third and fourth scenario presents a comparative analysis of the use of external resource inflows through the public sector—domestic debt retirement versus public works investment programmes. In the third scenario, it is assumed that the Government uses a significant amount of external inflows to retire domestic debt, implying fewer external resources for other expenditures. In the fourth scenario, instead of the Government repaying the domestic debt using external inflows, it uses the resources for major public investments such as infrastructure works. In other words, it is assumed that all the funds used for debt retirement in scenario three are used instead for public investment.

Major Findings

Building the above scenarios using the KIPPRA Treasury Macro Model (KTMM) generates different results, which are in turn used to asses the strategy with better outcomes in terms of the level of economic growth realized and jobs created. The major findings from these simulations are summarized in Table 2. The findings are reported as deviations from the base. All the scenarios lead to increased growth but with varying impacts on employment. The export-led policy generates more employment opportunities than the investment-led strategy.

On whether to retire debt or invest heavily in public investment, it is clear that it is better to invest, as this will lead to higher growth and employment in the economy. The spill over effects to the private sector are equally higher. Using external resources to repay domestic debt will lead to growth too but with less impact.

Conclusions and Recommendations

Three key policy issues emerge when the four policy scenarios are analyzed. First, is that the private sector should be the focus of any economic recovery efforts. Second, the export-led growth strategy has a faster response in terms of job creation. Finally, the investment led strategy would have to be put in place in order to sustain the potential of the economy to create jobs. A policy-mix of both investment and export-led growth is recommended to ensure immediate and sustained job creation.

The public works investment scenario is more superior than debt retirement using external resources in terms of employment creation. Indeed, under the assumptions, the ratio of domestic debt to GDP by 2007 is the same whether external resources are used to repay domestic debt or for public works investment programmes. Public works programmes achieve higher real growth and create more formal sector jobs. Such programmes should therefore be part of the economic recovery efforts.

About KIPPRA Policy Briefs

KIPPRA policy briefs are aimed at a wide dissemination of the Institute's policy research findings. The findings are expected to stimulate discussion and also build capacity in the public policy making process in Kenya.

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