Policy Brief

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Improving public policy making for economic growth and poverty reduction

Enhancing Investment Performance for Sustained Economic Growth in Kenya

The Kenya Vision 2030 aims at achieving a high and non-inflationary real Gross Domestic Product (GDP) growth of 10 per cent by 2012, and sustaining it thereafter. To achieve this growth, Kenya needs to increase public and private sector investment by at least 10 per cent of GDP over the next five years. Previously, the Economic Recovery Strategy (ERS) 2003-2007) had recognized that to achieve wealth and employment creation, the government should create an enabling environment to encourage domestic and foreign investors. Specifically, the ERS emphasized on investment in infrastructure and human resource development. It was estimated that Kenya required to increase Gross Fixed Capital Formation (GFCF) from about 16 per cent in 2002 to 22.2 per cent in 2007, the bulk (16.2%) of this to be undertaken by the private sector. Despite these objectives and targets, the Private Sector Development Strategy 2006-2011 notes that investor confidence has recently experienced a downward trend resulting in decelerated Foreign Direct Investment and slow growth in local investments. Domestic financing of investment has been declining, thus widening the domestic investment financing gap. Some investors have even re-located to neighbouring countries.

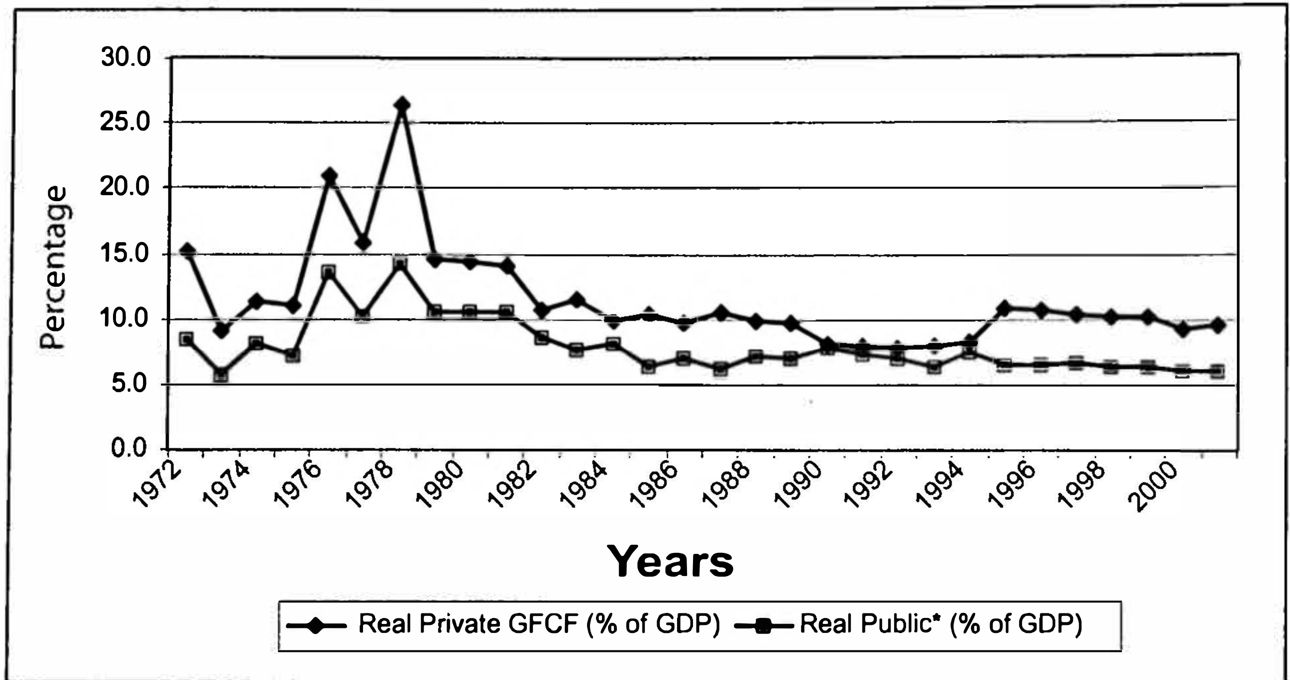
Issues in Investment Trends

Investment trends are captured by Gross Capital Formation (GCF), which comprises of Gross Fixed Capital Formation (GFCF) and changes in stocks or inventory investments. GFCF in Kenya has been the driving force of investment trends as it has accounted for the higher portion of Gross Capital Formation, averaging 89 per cent of nominal total investment between 1977 and 2003.

Between 1964 and 2003, the private sector had contributed a greater proportion to real gross fixed investment, with its highest and lowest proportions being 79.6 per cent and 50.8 per cent, respectively, and the average being 62 per cent. Figure 1 shows the trends of real GFCF (as a % of GDP) by the private and public sectors between 1972 and 2003. The trend shows consistency with the ERS aspirations over this period as the private sector GFCF has been dominating. It is also consistent with key lessons from Newly Industrialized Countries (NICs) on the pivotal role of the private sector in enhancing investment and attracting long-term foreign investment. Private sector GFCF's highest and lowest proportions of GDP were 26.3 per cent and 7.7 per cent in 1978 and 1992, respectively, and the average was

This policy brief is based on a forthcoming KIPPRA Working Paper on Investment Patterns, Trends and Policy Stances in Kenya, by Mbutu Mwaura, Rose W. Ngugi and Githinji Njenga.

Figure 1: Real private and public* GFCF (% of GDP), 1972-2003 (in 1982 constant prices)



Source: Author's calculations. GFCF data obtained from Economic Surveys, various issues, and GDP from the 2004 World Development Indicators

**Public sector includes central government, municipalities, councils and parastatals*

11.4 per cent for the period. On the other hand, the public sector GFCF as a percentage of GDP averaged 7.8 per cent, with its highest proportion being 14.1 per cent in 1978 and its lowest 5.5 per cent in 1973.

In terms of levels, the annual real GFCF has averaged Ksh 13.5 billion between 1972 and 2001, with the private and public sectors contributing Ksh 7.96 and Ksh 5.5 billion, respectively. The sharp increase in GFCF in 1978 can be attributed to the coffee boom while the increase between 1992 and 1995 is largely attributable to the construction of the Western Kenya Pipeline extension in 1994. The increase in private sector GFCF in 1994/95 can be explained by adoption of import liberalization policies, which enhanced importation of capital goods, and heavy investment in Information and Communication Technology (ICT) especially by commercial banks. Government policy pronouncement of giving less attention to public investment seems to have borne some fruits as public investment declined marginally between 1982 and 1983, although this was not sustained as it rose again in 1984. The decline in public gross fixed investment between 1990 and 1993 can be attributed to the aid embargo in early 1990s, which decreased government capacity to invest, combined with political uncertainty and ethnic clashes experienced during the formative period of multi-party democracy. There was also an acute shortage of foreign exchange in 1992.

Although government policy since independence has emphasized a mixed economy where both the private (local and foreign) and public sectors complement each other in development, the policy stances on the relative role of local and foreign

investment has changed over time. For instance, immediately after independence in 1963, the government stated in Sessional Paper No. 10 of 1965 *on African Socialism and its Application to Planning in Kenya* that, whereas foreign ownership and management of productive assets was allowed, foreign investors should be prepared to accept 'the spirit of mutual responsibility'. This was in pursuit of *Africanization* and *Kenyanization* policies. Later efforts of investment promotion, especially on incentives, were mainly in favour of foreign investors. The current Public-Sector Stakeholders Partnership policy recognizes the complimentary role of private and public investment.

In terms of sectoral concentration of investment, it has been established that whereas most government pronouncements have been inclined to physical infrastructure, human capital development and agriculture, real investment has been highest in the transport, storage and communication sectors, which accounted for about 25 per cent of total GFCF between 1964 and 2003. This is despite most investment incentives having been accorded to manufacturing, hotels, and mining sectors. Some of the sectors that have hitherto received policy priorities, such as agriculture, and have enjoyed more incentives, such as manufacturing, are among the six priority sectors that have been identified in the Vision 2030 as having the highest potential for economic growth.

Table 1: Cross country comparisons of Gross Capital Formation (%GDP) and Gross Domestic Savings (% GDP) and the Domestic Financing Gap (% GDP)

Country	GCF, GDS Financing Gap/ Periods	1964-73 Average	1974-83 Average	1984-93 Average	1994-2002 Average
Botswana	GCF	31.6	37.9	27.9	25.6
	GDS	6.8	23.4	40.9	39.5
	Domestic Financing Gap	25.8	14.4	-13.0	-13.8
Egypt	GCF	14.5	29.4	25.5	18.0
	GDS	10.3	14.6	[illegible]	[illegible]
	Domestic Financing Gap	4.2	14.8	10.4	6.9
Ghana	GCF	12.8	7.5	12.6	22.7
	GDS	11.0	6.8	5.2	[illegible]
	Domestic Financing Gap	1.7	0.7	7.4	[illegible]
Kenya	GCF	20.2	22.4	19.0	16.9
	GDS	19.8	17.7	17.6	[illegible]
	Domestic Financing Gap	0.4	4.7	1.9	5.6
Malaysia	GCF	19.0	27.2	29.6	[illegible]
	GDS	22.4	28.6	33.2	[illegible]
	Domestic Financing Gap	-3.4	[illegible]	-4.3	[illegible]
Philippines	GCF	20.9	29.5	[illegible]	21.7
	GDS	20.7	[illegible]	[illegible]	[illegible]
	Domestic Financing Gap	0.2	[illegible]	[illegible]	[illegible]

Source: 2004 World Development Indicators

Although specific gross fixed investments have been undertaken in the provision of government services in public administration (30%), education (13.5%), health (10%), and agricultural extensions (10%), the bulk of investment has been in the unspecified category of 'other services', which accounted for about 35 per cent between 1964 and 2003. 'Other services' are perhaps investments in military activities but which were not made public.

In terms of asset types, the major component has been the constructions (other assets are machinery and other equipment, transport equipment and land improvement and plantation development), which comprised 45.6 per cent of real GFCF between 1964 and 2003. In consistence with theory, the performance of the construction sector is closely associated with the performance of the entire economy. For instance, the sector had a general upward trend in the first two decades of independence up to 1982, when it almost had a constant trend for ten years

before it started declining, and later picking up again in 1994.

Investment Financing

Table 1 shows selected cross-country comparisons of GCF and Gross Domestic Savings (GDS) as percentages of GDP. The difference between GCF and GDS gives the domestic financing gap, implying that a country has to seek external finance to meet her investment needs. The domestic financing gap in Kenya was lowest (0.4%) in the first decade of independence (1964 to 1973) when the economy was doing well and highest (5.6%) during the liberalization period (1994 to 2002). Between 1964 and 1973, Kenya was doing better compared to Botswana, Egypt and Ghana, which had domestic financing gaps of 25.3 per cent, 4.2 per cent and 1.7 per cent, respectively. For that period, Kenya's performance was comparable to Asian countries such as the Philippines, which had a domestic financing gap of 0.2 per cent.

Domestic savings has been the major source of financing of GCF, averaging 65.8 per cent over the 1977 to 2003 period. This was followed by grants and net borrowing from abroad, with a proportion of 21.6 per cent and 12.6 per cent, respectively, of total GCF financing. However, the proportion of GCF financed by domestic savings has been declining from an average of 79.3 per cent (1983-1987) to 60.3 per cent (1995-2003). The declining trend in aggregate domestic savings could partly be attributed to low interest rate on deposits; the 1980s' world economic recession coupled with high 1980s' world oil crisis; and the aftermath of the 1982 political disturbances.

Investment Incentives

Majority of the specific investment incentives such as Investment Deductions Allowance (IDA), Industrial Building Allowance (IBA), and Mining Deduction Allowance (MDA) that have been stated in various budgetary speeches and other government publications have more often targeted foreign investors. In addition, some have targeted a variety of sectors while others have been sector-specific.

The fiscal incentives that have been given to investors have broadly aimed at improving the business environment to make industries competitive, and encourage industries (especially micro and small enterprises) to be established in the rural areas or re-locate to rural areas for balanced development. Various fiscal instruments, including Customs and Excise duties, VAT, and income taxes have also been used. One fiscal instrument that cuts across several sectors and which has been used as an incentive is corporate tax. For instance, to make the country attractive for investment and to enhance profitability of the firms, the main corporate tax rate has been reduced several folds from 42.5 per cent in 1989/1990 to 30 per cent and 37.5 per cent currently for resident and non-resident companies/branches, respectively.

Countries such as Brazil and Mauritius have successfully used Export Processing Zones (EPZs) as incentives designed to strictly promote exports, attract investments, and spur technology transfer and general industrialization.

Sessional Paper No. 2 of 1997 highlighted that the incentives given under Manufacturing Under Bond (MUB) and EPZs would be harmonized to encourage local investors to increase manufacturing for export. The EPZ incentives, spread in the revenue Acts, are probably the single largest bulk of incentives and account for the highest amounts of foregone revenue. However, there has been concern that most EPZ firms close down after the first ten years of prime fiscal incentives only to open up as new companies and continue enjoying the incentives. Again, the EPZ provision for 'no-value added requirement' goes against Kenya's aspiration for becoming a middle income country by the year 2030 and is against the spirit of the Investment Promotion Act 2004. The EPZ Authority Act also has provision of unrestricted employment of foreigners in technical and training positions.

Institutional Framework

Due to its crucial role in enhancing investment, the government has been restructuring the Kenya Investment Authority and Export Processing Zone Authority to intensify their programmes. This will enable the investment authority to be a 'One-Stop-Shop' to encourage domestic and foreign investments and attract modern technology. Furthermore, the Private Sector Development Strategy calls for acceleration of institutional transformation in order to enhance service delivery.

Legal and Regulatory Aspects

All legislations relating to investment have been consolidated into the Investment Promotion Act (2004) to clearly regulate the legal rights and obligations for domestic and foreign investors and provide legal guarantees. In this Act, the Investment Promotion Council was renamed Kenya Investment Authority with a broad mandate of promoting the opportunities for investment in Kenya, both locally and internationally.

According to the Act, a local investor with at least Ksh 5 million worth of investment may apply for an investment certificate, but must register the investment with the investment authority. The minimum capital requirement for foreign investors is US$ 100,000, and holding of an investment certificate is optional. However, there are still concerns that this minimum capital requirement is still high.

The Act further stipulates that an applicant who fulfills the requirements is entitled to an investment certificate if the activity is beneficial to Kenya in terms of employment creation; acquisition of new skills or technology for Kenyans; generation of government revenue; increase in foreign exchange; utilization of domestic raw materials; adoption of value addition in the processing of local, natural and agricultural resources; and promotion of development of Information and Communication Technology (ICT). Once the Kenya Investment Authority has issued the certificate, it can only revoke it after it has given 30 days written notice and reasons thereof, during which time the holder has an opportunity to make representations as to why the investment certificate should not be revoked.

The investment certificate sets out the licenses (including registration, permits, approval or authorization required by law regardless of how it is described) that are necessary for the proposed investment. Once an investor has the investment certificate, the license(s) are deemed to be issued and the necessary license fees are paid within six months of the issue of the certificate. However, this is subject to other industry/ sector-specific conditions. For instance, for general businesses, registration particulars should be submitted within six months after the issue of the certificate and, for the hotel industry, production of a certificate of medical officer of health is a requirement.

Efforts to Improve Investment Climate, and Outstanding Constraints

Although there have been various efforts to improve the investment climate in Kenya, issues such as infrastructure, insecurity, high cost of doing business, and bureaucracy, among others, are still outstanding constraints to growth of investment.

An investment forum in May 2005 identified some specific concerns that needed to be addressed to improve the investment climate. The main issues of concern in terms of attracting foreign investment were:

- Inadequate flexibility of FDI entry;
- Work permit awards;
- Lack of investor after-care capacity;
- Lack of investment guidelines in agricultural land transactions;
- Fast-tracking issuance of the East African Community business visas; and
- Harmonization of East African Community tax reforms.

The main issues in terms of attracting domestic investors were identified as:

- VAT refund delays;
- Weak business linkages; and
- Lack of performance benchmarking for domestic manufacturers.

It was even suggested that these concerns should be brought to the attention of the National Economic and Social Council (NESC). However, an assessment of the current status of the various measures shows that their implementation is still wanting. In majority of the cases, only committees to spearhead these issues in various government ministries/agencies have been formed. In terms of reducing the cost of doing business in the country, 330 out of 1,325 licenses have been abolishied and 379 modified since 2005/06. In addition, an implementation plan for the Private Sector Development Strategy has been developed.

Conclusion and Recommendations

Various country experiences have shown that a conducive investment climate is one of the most effective strategies of enhancing fast economic growth and thus reduce poverty. For instance, the World Bank Survey (2004)

noted that investment climate improvements in the 1980s and 1990s doubled private investment in China and India, two of the fastest growing economies in the world today. It is, therefore, imperative that the following issues are addressed in order to raise investors' confidence for private and public sector investments to increase by 10 per cent and spur economic growth as envisaged in Vision 2030.

Enhance implementation of various investment initiatives

There is need to fast-track the various investment enhancing initiatives up to the implementation level. For instance, there is need for the Kenya Investment Authority to ensure complete implementation of the nine blue book measures that were given priority by the investment stakeholders in May 2005. Implementation of the Private Sector Development Strategy also needs to be fast-tracked and adequately monitored.

Enhance partnership with the private sector

Public-private sector partnership as outlined in the Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC) needs to be enhanced under the Public Sector-Stakeholders Partnership (PSSP) framework. This is particularly due to efficiency and higher productivity associated with the private sector. Lessons from Newly Industrialized Countries demonstrate the pivotal role of the private sector, supported by conducive public policy, in attracting long-term foreign investment.

Focus more on regional investment aspects

In Kenya, more focus should be directed to understanding regional aspects of development, which determine public and private sector investment. It is worthwhile to note that the Kenya Investment Authority has started working closely with local authorities in initiatives aimed at offering regional-specific solutions to factors that hinder public and private sector investment. There is, however, need for more research in these areas to understand the regional dynamics in view of the persisting regional disparities.

Provide more incentives to the services sector

The services sector contributes about 64 per cent of GDP. However, this sector has not been given adequate attention in terms of providing appropriate investment incentives. Most of the specific investment incentives have been accorded to manufacturing, agriculture, hotels and mining, while most of the investment between 1983 and 2003 occurred in the transport, storage and communication sector, which is an economic service.

Incentives for local and foreign investors

Most investment incentives target foreign investors while only a few target domestic investors. Local investors act as magnets for attracting foreign investors and should, therefore, be provided with more incentives. Furthermore, there is need to also strike a balance between domestic direct investment

and foreign direct investment with an aim of identifying Kenya's niche.

Regulatory aspects

The minimum capital for foreign investors is still high and acts as an entry restriction to foreign investment. Kenya could consider reviewing this restriction by, for instance, making the attainment of minimum capital a prerequisite to incentives. In addition, export processing firms ought to be bonded for a specific period of time after the expiry of their ten year prime fiscal incentives period.

Enhance mobilization of domestic savings for investment

More efforts are needed to enhance mobilization of domestic savings especially for long-term investment. The recent massive over-subscriptions in Initial Public Offers (IPOs) show that the public has confidence with the stock market and the economy has a lot of potential in mobilizing long-term capital. In addition, recent pension's reforms such as the requirement that one accesses retirement benefits only on attainment of 55 years can act as sources of long-term capital. Therefore, there is need to enhance reforms aimed at strengthening the intermediation role of the financial sector and enhance the environment for private savings. This would also help narrow the widening domestic financing gap.

Disaggregate information on government services

The bulk of provision of government services of investments under the unspecified category of 'other services' needs to be disaggregated into the various services offered by the government. This is possible especially given that previous military expenditure items are now captured in government documents. For instance, the revised levels of gross fixed capital formation from 1998 have included government expenditure on military durable goods (transport and machinery equipment and other installations). This disaggregation would enhance accountability on the expenditure of public resources.

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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