A Review of Kenya's Current Industrialization Policy

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Abstract

Industrialization has been embraced by many developing countries as a means of achieving structural transformation of their economies. In Kenya, the goal of industrialization has long been held as a strategy for economic development. Recently it has received emphasis as the main strategy for addressing the principal challenges of development in Kenya—employment creation and poverty eradication. As such, a policy framework was developed in 1996 for achieving industrialization by the year 2020. The major departure from previous polices on industrialization is its emphasis on selective encouragement of specific industries through a broad array of support by the government over a 25-year period, by which time Kenya will have achieved newly industrializing country status. The present policy framework considers industry as the leading sector for addressing the development challenges faced by the country. It therefore proposes to provide "selected" industries, at various stages in the industrialization process, with the support that will enable them to grow and become exporters of their products. This review examines the major consistencies and inconsistencies in the present and past policies on industrialization. The apparent failure in the strategy is the absence of a holistic approach that considers and addresses the constraints, conflicts and trade-offs facing producers in all sectors of the economy.

Contents

Abstract ..... **iii**

Contents ..... **v**

Executive summary ..... **vii**

1 Introduction **1**
- 1.1 Import substitution industrialization 2
- 1.2 Export-oriented industrialization 4

2 Review of current industrialization policies **9**
- 2.1 Macroeconomic policy framework 12
- 2.2 Trade policy regime 12
- 2.3 Industrial policies 16
- 2.4 Infrastructure development policies 22
- 2.5 Human resource development policies 24
- 2.6 Institutional development framework 26

3 Critique of the policy framework **28**
- 3.1 Weaknesses in the overall industrialization strategy 28
- 3.2 Critique of specific policies 30
  - *3.2.1 Incentive framework 30*
  - *3.2.2 Institutional challenges 33*
  - *3.2.3 Resource implications and trade-offs 34*

4 Conclusions and recommendations **35**

References and additional reading **39**

Executive summary

Kenya has embraced the goal of industrialization as a way to transform the structure of the economy. The current industrialization strategy aims to transform the economy into that of a newly industrializing country by the year 2020. The strategy emphasizes selective encouragement of industries to produce for export and in the process increase their employment potential. The strategy, however, is different from past strategies because of two innovations. First, industry is for the first time taken to be the leading sector in economic development, and second, specific industries are for the first time earmarked for government support.

The strategy for industrialization is to be implemented over a two-stage period. In the first phase, the government will selectively encourage labour-intensive, resource-based and light manufacturing industries, where the country enjoys comparative advantage. In the second stage, policy will target intermediate and capital goods industries that are more technology and capital intensive but that must wait until constraints of infrastructure, technology, human capital and savings are removed. These industries, which include metallurgical, non-petroleum-based chemical, petro-chemical, pharmaceutical, machinery and capital goods industries, are expected to produce initially for the domestic market and eventually for the export market. If successful, this strategy will result in a diversified and dynamic industrial base by the year 2020 with a GDP per capita almost five times its 1996 level.

Policy framework

Unlike previous industrialization strategies, the present one specifically directs government to intervene to remove structural bottlenecks and improve information flow, thus removing the coordination failure that characterizes private

sector activities in developing countries. The policy framework for industrialization, therefore, seeks to provide incentives, improve capabilities and provide an appropriate institutional framework that will ensure an industrialization process led by the private sector. The policies outlined for achieving this can be divided into several parts:

- macroeconomic policy framework
- trade policy regime that includes incentives for export promotion as well as regional integration initiatives
- industrial policies that target incentives to particular industries; they consist of internal trade policies, technology policy, policies on the relative role of large- and small-scale enterprises and industrial location policies
- infrastructural development policies
- human resource development policies
- institutional development policies

Critique of policy framework

The current industrialization strategy is the government's most ambitious yet. However, there are four outstanding weaknesses in the overall strategies.

- Overreliance on the government to pick winners, as happened in Korea and Taiwan, without taking into account if the same preconditions exist in Kenya. These were a *skilled labour force* and a *relatively high degree of income equality*. The first precondition made it possible to create an efficient civil service with a good implementation record. The second precondition ensured that civil servants were able to operate free of pressure-group politics and negated the need for government redistribution policies that would have been inimical to investment and growth.

- Failure of the strategy to highlight links between the industries promoted in the two stages of the strategy. This

may lead to underutilization of the industries encouraged in the second stage. The substantial economies of scale necessary for the second-stage industries and their subsequent need for a local market before developing competitiveness for the export market require that there be coordination between the industries promoted in the two stages.

- Failure to undertake simultaneous improvement of agriculture, yet this is crucial for the success of the industrial sector. As Kenya is predominantly an agricultural country, the bulk of the industries will be agro-based. The development of the agricultural sector to provide the necessary raw materials such as cotton for textiles, hides and skins for leather industries, and industrial and beverage crops for processing industries, will therefore be a necessary prerequisite.
- Failure to consider the responses of actual and potential competitors. The move towards free trade and regional integration could mean that the country must set a strategy that takes into account developments in other countries, particularly in the COMESA—the Common Market for Eastern and Southern Africa—region.

Specific policies

The export promotion incentive framework is inadequate on at least three counts:

- It fails to consider the link between the achievement of international competitiveness and the penetration of export markets. Consequently, it pays insufficient attention to issues of cost structure and product quality, which are crucial to being competitive.
- Some of the proposed export promotion measures such as the VAT–duty drawback scheme require superior organizational capacities, which may presently be unavailable in the civil service.

- Failure by the government to consider offering an export insurance scheme to exporting firms may be counterproductive given the risk aversion of the owners of small- and medium-scale enterprises—a characteristic that has been identified as impeding their growth.

To secure the expected response from the private sector, policies should be clear, unambiguous and consistent. The policy framework fails to achieve this in some respects:

- The proposed two-phase industrialization strategy implies a reversal in the second phase of the trade liberalization measures undertaken in the first phase. This reduces the credibility of the initiative.
- There is danger of macro incompatibility. This is because the fiscal implications of phase two industrialization will clash with the government's stated desire to maintain a balanced budget and achieve a surplus. Investor response may subsequently be distorted.

The proposed solutions aimed at easing financial constraints facing the small- and medium-scale enterprises are inadequate as they advocate credit subsidies to small-scale enterprise, overburden the Central Bank by requiring it to screen borrowers, and focus too much on public savings and other institutional weaknesses in the financial sector to the exclusion of other factors.

The policy framework does not intend to change the current regional concentration of industries immediately. Rather it envisages expanding industrialization to rural areas by subsidizing investing firms and improving infrastructural access in these areas. This may be difficult and counterproductive because of limited financial capacities of local authorities and the probable demise of rural small- and medium-scale enterprises once infrastructural provision offers urban companies access to markets.

Some institutions that are vital to the industrialization objective such as the National Industrial Development Council, the Executive Roads Management Board and the civil service have organizational and other flaws that should be addressed to increase their effectiveness. Such institutions will need to focus on the most productive actions and leave the rest for the private sector to provide.

The policy framework fails to consider important trade-offs and conflicts:

- conflict between the fiscal strategy required for sound macroeconomic management and the ability to provide additional incentives through increased expenditure or revenue foregone
- conflict between concentrating complementary investment in high-potential areas (such as the Mombasa–Nairobi–Kisumu corridor), likely to achieve lower aggregate production costs, and spreading resources among political constituencies
- the need to balance the competing interests of savers and borrowers
- conflict between worker interests and those of employers
- the need to balance between subsidies and a well-functioning market economy
- the need to balance between faster economic growth and attaining national objectives of employment creation and poverty alleviation

Recommendations

- In the trade policy regime, more attention should be paid to the measures that will enable Kenyan firms to cut costs and become competitive through
  - promoting competition in the manufacturing sector by reducing the entry and exit regulations that presently limit

the number of firms in manufacturing; for example the prior requirements for approvals practised by the Investment Promotion Centre can be considerably relaxed if environmental safeguards are undertaken
– efficient provision of infrastructure, which would reduce unit production costs

- Export promotion measures can be improved with better administration of the VAT–duty drawback scheme and by adopting an incentive framework that would give qualifying firms rapid access to well-targeted, duty- and tax-free imported inputs.
- A managed full import liberalization programme would make export promotion measures unnecessary if protected firms are prewarned of the impending reforms and all the infrastructure bottlenecks are removed beforehand to make them more competitive.
- The government will need to provide the small- and medium-scale exporters with adequate safeguards to reduce the risks of exporting that might otherwise impede their penetration of export markets.
- In regional integration, the country needs to take into consideration the developments in these countries when strategizing for industrialization. A starting point would be to establish, under the existing research institutes, a department charged with researching or collating research and data on developments in the region.
- The two phases of industrialization should not be looked at as separate entities but rather should be closely linked so as to provide optimal investor response.
- Credit subsidies can be provided more efficiently by linking them to objective criteria like export performance or channelling them through restructured development banks.

This policy worked effectively in South Korea and Taiwan to promote exports.

- A more elaborate policy aimed at increasing savings should include a population policy.
- A more effective foreign direct investment policy should target investments at minimum costs while taking into account the country's resource configurations.
- The monetary authorities should give incentives to private banks to undertake institutional financial innovation that will encourage group lending. This would help to minimize the costs that presently constrain lending to small- and medium-scale enterprises.
- Regional dispersion policy will require a cost–benefit analysis to justify the increased financial burden to the rural local authorities of providing water subsidies to industries locating there. The analysis is also required to determine whether the cost of the demise of local small- and medium-scale enterprises due to opening up the rural areas will be outweighed by the greater access to raw materials for urban-based industries.
- National consensus is needed on the pattern of industrialization and the sacrifices necessary to achieve the goal of industrialization.
- To deal with institutional challenges, government arbitration may be necessary to resolve the distribution conflicts within the Executive Roads Management Board charged with administering the Roads Maintenance Levy Fund. Further, it may be necessary to clearly link expenditure on road maintenance to the levies collected to minimize the possibility of abuse.
- The functional overlaps that exist between the bodies created to facilitate the industrialization process may hamper

their effectiveness. Therefore, there is need to safeguard against creating bureaucracies.

- The actions proposed for civil service reform should take into account the need to build capacity, which would require additional strategies such as providing incentives and training and setting up a proper and enforceable code of ethics. This is an important requirement for the program's success in supporting industrialization.
- The policy framework should take into account the conflicts and trade-offs of various policies and programmes through analysis involving the government and all stakeholders. This is a necessary prerequisite for the programme to succeed.

1 Introduction

Industrialization, defined as the process by which a country builds its capacity to process raw materials for consumption or further production (Todaro 1985), is never desired as an end in itself but as a means towards economic development.[1] Thus Kenya, like many developing countries seeking to industrialize, has embraced the industrialization goal as a means of achieving structural transformation of the economy.

Kenyan official policy has, by recognizing the mutual and reinforcing relationship between industry and agriculture, pursued the development of both sectors simultaneously on the understanding that a productive and vibrant agricultural sector is a sound foundation for industrialization (Kenya 1965). Development policy in Kenya has over time, therefore, given uniform encouragement to both sectors as the *twin engines* of development. In 1972 agriculture contributed 36% of GDP while industry contributed 17% with services contributing the balance, by 1996 the contribution of agriculture had declined to 27% of GDP while that of industry had increased to 18%, with services contributing up to 55% of GDP.

Two broad strategies of industrialization have been pursued since independence—import-substitution industrialization and export-oriented industrialization.

[1] Although under United Nations classification, the industrial sector includes four divisions (mining, manufacturing, building and construction, and public utilities), manufacturing dominates, with formal sector manufacturing constituting about 73% of the total industrial sector output between 1983 and 1997 (see Wagacha and Ngugi 1998). Therefore, the paper focuses on the manufacturing sector.

The rest of the paper reviews the policy framework for industrialization as spelled out in Sessional Paper No. 2 of 1996,[2] *Industrial Transformation to the Year 2020,* and the Eighth Development Plan for the period 1997–2001, *Rapid Industrialisation for Sustained Development* within the context of the industrialization policy pursued since independence. The next section therefore shows the changes in industrial strategy since independence, section 2 gives a brief review of the policy framework, and section 3 provides an overview and critique of the industrial strategy. In section 4 we draw conclusions and make policy recommendations.

1.1 Import substitution industrialization

The import-substitution industrialization strategy, pursued mainly (but not entirely) in the first two decades of independence, was largely a continuation of the industrial strategy pursued by the colonial administration.[3] Emphasizing the "infant-industry" argument, it advocates domestic production of import substitutes by industries protected from international competition. In Kenya, the instruments of protection included quantitative restrictions, high tariffs on competing imports and overvalued exchange rates as well as broad-based economic controls that subsidized the industrial sector. This was the phase that emphasized the domestic production of previously imported consumer goods that the growing urban wage class demanded. The initial impact of this strategy on economic growth was positive while the easy phase of import substitution was undertaken. The gross domestic

[2] This was subsequently reprinted as Sessional Paper No. 2 of 1997.

[3] According to Anyang Nyong'o (1988 p. 11) there were recommendations as early as 1939 that import substitution industries be established in British colonies.

product (GDP) growth rates averaged 6% in the first decade and about 4% in the second. Part of this growth rate was attributed to an equally impressive growth rate in manufacturing value added, which averaged 8% in the two decades. The impressive growth in manufacturing value added of 11.7% per annum, achieved during the period 1970–75, was not matched in the second decade, when it grew at a much slower 4.9% per annum (McCormick 1998 p. 194).

However, problems arose, as the excessive government control mechanism put in place to support the strategy stifled progress to further stages of import substitution. These stages would have entailed the production of intermediate and capital goods. By the second decade, it was quite clear that the industrialization strategy was not achieving its development objectives of creating employment and reducing poverty. The ensuing economic distortions resulted in macroeconomic imbalances and slowed overall economic growth (Swamy 1994, Kenya 1986). The small domestic market (made smaller by the collapse of the East African Community) resulted in under-utilized capacity,[4] further compounding this problem and making it not viable to undertake further expansion of industrial capacity based on this strategy. The only logical option was to seek export markets and thus adopt an export-oriented industrialization policy.

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[4] Capacity underutilization can be part of a firm's competitive strategy. Firms may deliberately set a strategy of "queue investment" by creating excess capacity during lean times as they wait for better times in future. The excess capacity acts as a cushion for future development or competition. In the short run, however, this practice results in high unit production costs and may not be competitive. The collapse of the East African Community may have resulted in excess capacity for such firms quite apart from the fact that their target production had to be reduced.

1.2 Export-oriented industrialization

This strategy was officially spelled out in Sessional Paper No. 1 of 1986 on *Economic Management for Renewed Growth* as part of the structural adjustment reforms adopted by the government to remove the distortions created by the previous policy regime. The lack of commitment to the macroeconomic and public expenditure reforms, urged by the World Bank and the International Monetary Fund (IMF) since 1979, ensured the failure or premature withdrawal of these reforms.[5] The 1986 document therefore represented an official attempt to establish ownership of these and other reforms advocated by the two institutions. The sessional paper therefore offered specific incentives to encourage industries to produce for export as well as other reforms aimed at improving the overall macroeconomic environment. The trade liberalization measures proposed in the paper included

- abolition of quantitative restrictions
- harmonization[6] and lowering of tariff levels
- export promotion incentives such as manufacturing under bond, the "green channel system" for administrative approval, export processing zones, and the export compen-

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[5] For example policy statements in earlier development plans recognized the practical importance, for long-term survival of domestic industries, of exports to regional and international markets (see Kenya 1966, 1970, 1974, 1979, 1984).

[6] Harmonization of tariffs refers to the reduction in the dispersion of tariff rates either between a set of countries (such as Kenya, Uganda and Tanzania) or between the country and the rest of the world. In all cases this normally involves convergence towards the lowest levels and is therefore a form of trade liberalization.

sation scheme (in existence since 1974)[7]

- adoption of a competitive exchange rate policy

Although these policies sought to promote exports of manufactured goods from the previous import-substituting industries, they did not specifically target any industries. The incentives provided would, it was presumed, elicit an export-supply response from the many industries that constituted Kenya's diversified industrial base, established under the previous regime.

Implementation of the proposed policies was gradual and punctuated by reversals. For example, the 1989–93 development plan, which elaborated on the export promotion strategy, lamented that the proposed incentives had not become fully operational three years after they were mooted. Their effectiveness was also hampered by the lack of fiscal discipline, which resulted in macroeconomic imbalances that had a negative impact on investment. Therefore, the magnitude of the export-supply response was not as high as expected. There was, nevertheless, an increase in non-traditional exports between 1985 and 1990 (Swamy 1994).

During the 1990s, weaknesses in implementing the reform programme reversed previous achievements in the export sector. For example, fiscal indiscipline and associated

[7] The manufacturing under bond scheme encouraged production for export through the provision of waivers on imported inputs; export processing zone schemes tried to establish enclave production of exports by foreigners by providing them with special incentives not available to domestic industries including duty and tax waiver, full remission of earnings, freedom to employ foreigners and infrastructure support; the green channel system sought to hasten the process of administrative approvals for import licensing, foreign exchange allocations and export approvals for exporters.

macroeconomic imbalances, the reimposition of import licences and foreign exchange controls led to a slowdown in the growth of exports. Moreover, reforms in the external trade regime were not reinforced by reforms in the internal trade regime. Consequently, price controls and licensing procedures as well as other regulations continued to fetter economic activities in the productive sectors and in manufacturing in particular. The worsening terms of trade and deteriorating relations with the donors over unfulfilled expectations further compounded these problems.[8]

The overall impact of these problems on the manufacturing sector and overall economic growth was negative. The growth in manufacturing value added fell from 5.2% in 1990 to 1.2% in 1992 while GDP growth fell from 4.2% in 1990 to 0.4% in 1992. Some of the far-reaching structural reforms undertaken since 1993 to reverse this decline included the following:[9]

- price decontrols[10]
- removal of all import licences[11]

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[8] The terms of trade have fluctuated widely. For example, between 1987 and 1992 there was a 7% deterioration, but there has been no visible trend.

[9] April 1993 marked the beginning of a period of more serious implementation of reforms agreed upon with donors. However, the emergence of differences with donors over details of reforms led to suspension of aid. See Ikiara and Ndung'u (1999) for a detailed review of the reform measures undertaken since 1993 and Swamy (1994) for those before 1993.

[10] By the end of 1995 virtually all prices, including those on petroleum and maize that had previously experienced the highest resistance to price reform by the government, were liberalized. This was the culmination of a process that had begun in the 1980s.

- tariff reductions[12]
- liberalization of foreign exchange markets[13]
- privatization of public enterprises[14]
- civil service reforms[15]
- strengthening the VAT–duty drawback scheme introduced in 1991 and the removal of the export compensation scheme, which had been abused

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[11] The attempt at import liberalization made in the period between 1988 and 1990 was relatively more successful than that of the earlier period 1980–84. Consequently by July 1990, the policy was to "automatically" license all imports except those restricted for reasons of health or public safety. The practice was, however, different as official discretion was involved in granting these licences. The 1993 reforms served to reduce the scope for discretion.

[12] The production weighted tariff rates declined from 31.8% in 1990/91 to 22.21% by 1994/95. Similarly the average tariff rates declined from 47.17% in 1990/91 to 27.27% by 1994/95. This reinforced a general downward trend in tariff rates that had been ongoing since the 1980s.

[13] By November 1993 a policy of market-driven exchange rates had been implemented save for a few restrictions on capital flows that were removed by January 1995 (see Ndung'u 2000).

[14] This remains a contentious part of the reform process and its inclusion here simply represents the time when government undertook to implement some of the reforms that had been earlier agreed upon. For example, in 1990 the State Corporation Act was amended in readiness for restructuring and sale of the 250 or so enterprises owned by the government in part or whole. The Executive Secretariat and Technical Unit was established in May 1992 to implement the sale of these enterprises. By January 1996, 76 of the 207 enterprises registered for sale had been privatized.

[15]Some initial civil service retrenchment had taken place on a voluntary basis in 1993 (see Ikiara and Ndung'u 1999 for details). A more intensified restructuring and reform programme is currently taking place.

These reforms seemed to mark an ideological shift in government policy away from the state to growth led by the private sector (Kenya 1994). State involvement would be limited to the more traditional role of providing an enabling environment: macroeconomic stability, physical and social infrastructure, and law and order. Private sector initiative was therefore expected to form the basis of future growth.

The reform efforts and policy shifts seemed to work initially (over the 1994–96 period) as investment and GDP growth improved following renewed relations with the donor community. For example, growth in manufacturing value added rose from 1.2% in 1992 to 1.8% in 1993 and 1.9% in 1994 while GDP growth rose from 0.4% in 1992 to 3.0% in 1994. In 1995 and 1996 manufacturing value added grew by 3.9% and 3.7% respectively while total GDP grew by 4.8% and 4.6% respectively. This may have been an initial response to the reform efforts, not all of which would have a positive effect on manufacturing in the short run.[16]

Decline set in again after 1996 as government slackened in its implementation of some of the reforms agreed upon and donors changed focus to governance issues as the basis of future aid.[17] The lack of transparency in the reform process generated opportunities for rent seeking and was working against some of the proposed reforms. In addition, corrupt practices in the civil service and other public enterprises were

[16] For example, removal of price controls and foreign exchange controls had a positive impact on the sector, but the exposure to increased competition from imports, especially when inadequate and deteriorating infrastructure increased their unit costs, would certainly have a negative impact on manufacturing.

[17] GDP growth fell from 4.6% in 1996 to 2.3% in 1997 and 1.8% in 1998.

again receiving attention from the donor community. The withdrawal of IMF support in 1997 therefore worsened the situation, and this partly explains the economic stagnation Kenya has been experiencing.

It is against this background of overall economic decline and worsening situations of poverty and employment that the policy framework on industrialization has been formulated. The government's stated objective in the strategy is to create employment and eradicate poverty through accelerated economic growth based on a sustained industrialization drive. This strategy has been inspired by the success of a similar effort undertaken by the East Asian economies. In the next section we briefly review this strategy.

2 Review of current industrialization policies

The current industrialization strategy, as outlined in Sessional Paper No. 2 of 1996, has the objective of achieving the transformation of the Kenyan economy to a newly industrializing country by the year 2020. The current Eighth Development Plan (Kenya 1997) is the first 5-year planned implementation programme based on the longer-term policy framework. It outlines specific programmes and policies to be pursued over the first 5 years (1997–2001) of the 25-year industrialization drive. The strategy outlined in the two documents emphasizes selective encouragement of industries to produce for export and in the process increase their employment potential.

Two innovations, however, make the present strategy different from past strategies: 1) industry is for the first time taken to be the leading sector in economic development and 2) specific industries are for the first time earmarked for government support. The decision to consider industry as the leading sector

in economic recovery is based on the perceived vulnerability of agriculture to many factors outside policy-makers' control,[18] which reduce its reliability as a source of sustained growth. Industry, on the other hand, has shown remarkable resilience and has potential for providing high and dynamic growth. The conclusion that follows from this is that

> to ensure stable and sustainable economic growth, the prospects lie more with the development of industry . . . it is [therefore] necessary to design appropriate measures that would enhance its development. (Kenya 1997 pp. 12–13)

The proposed industrialization strategy outlines some of the measures to be implemented, to industrialize over a two-stage period. In the first phase, the government will selectively encourage labour-intensive, resource-based and light manufacturing industries, where the country enjoys comparative advantage. To be targeted in this phase are primarily small-scale industries that use locally available raw materials and simple labour–intensive technologies and are therefore capable of generating employment. Examples are agro-based industries like: textiles; horticultural processing; skins, hides and leather; tea, coffee and sugar processing; and building and construction, such as brick manufacturing (Kenya 1996). The growth rate of industrial production during the first phase is expected to be between 8 to 10% per annum and the annual GDP growth rate is expected to reach 6.8% by the end of the phase.

In the second phase, policy will target intermediate and capital goods industries that are more technology and capital intensive but that must await the removal of infrastructure, technological,

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[18] Two exogenous factors that adversely affect agriculture are weather and unstable terms of trade for agricultural exports.

human capital and savings constraints. These industries, which include metallurgical, non-petroleum-based chemical, petrochemical, pharmaceutical, and machinery and capital goods industries, are initially expected to produce for the domestic market with the export market being their eventual goal. The growth rate of industrial production during this phase is expected to accelerate to between 12 to 15% per annum and the annual GDP growth rate to 10.6% by the end of the phase. If successful, this strategy will result in a diversified and dynamic industrial base by the year 2020 with a GDP per capita that is almost five times its 1996 level.

Unlike previous industrialization strategies, the present one specifically directs government to remove structural bottlenecks and improve information flows that would remove the "coordination failure" that characterizes private sector activities in developing countries. The policy framework for industrialization, therefore, seeks to provide incentives, improve capabilities and provide an appropriate institutional framework that will ensure an industrialization process led by the private sector.

The policies outlined for achieving this can be divided into several parts:

- macroeconomic policy framework
- a trade policy regime that includes incentives for export promotion as well as regional integration initiatives
- industrial policies that target incentives to particular industries; they consist of internal trade policies, technology policy, policies on the relative roles of large- and small-scale enterprises, and industrial location policies
- infrastructure development policies
- human resource development policies
- institutional development framework

2.1 Macroeconomic policy framework

A successful industrialization strategy driven by the private sector will require a stable macroeconomic environment achieved through sound monetary and fiscal policies. Fiscal policy will seek to reduce the budget deficit and by so doing minimize its undesirable effects on prices and interest rates. This objective will be achieved through streamlining expenditure and taxation policies with the aim of keeping public expenditures in line with public revenues. Monetary policy will seek to achieve price stability, lower interest rates and achieve a realistic exchange rate by, among other things, aligning the growth of money supply to the growth of economic activity and the achievement of a sustainable balance of payments position.

2.2 Trade policy regime

The present outward-oriented industrialization strategy encourages industries to produce for export or to undertake efficient import substitution with the goal of eventually increasing exports. A trade policy environment has therefore been put in place to subsidize exporting activity and so make production for exports profitable. The government has also undertaken to further liberalize trade. These efforts will involve rationalizing and further lowering tariffs, pursuing regional trade arrangements and providing export promotion incentives.

DEEPENING OF TRADE LIBERALIZATION

Kenya is committed to the principle of free trade through multilateral negotiations under the auspices of the World Trade Organization, of which it is a member. This implies that further trade liberalization measures are to be undertaken with the long-term aim of achieving a zero tariff trade regime, as advocated by that multilateral body. The industrial sector will need to become more competitive to survive under this regime. However, to safeguard against the dumping of poor quality imports, counter-

vailing duties will be used in addition to the imposition of minimum quality standards for imports by the Kenya Bureau of Standards. These efforts will amount to an increase in the use of non-tariff barriers to protect domestic industries.

However, if judged by the proposed industrialization strategy, the government's commitment to free trade may be more apparent than real. During the first phase of this strategy, when the government promotes labour-intensive manufacturing industries that utilize local raw materials, domestic raw material suppliers are likely to initially require protection from more competitive imports. For example, the textile industry had to rely on locally produced cotton for some time despite the inefficiencies in the local cotton industry that resulted in poor-quality cotton. Under a system of free trade, domestically produced cotton would likely no longer be the raw material of choice, as the textile industry would probably opt for imported cotton.

During the second phase of industrialization, the government has actually committed to reimpose trade barriers within the World Trade Organization agreements for some time to protect intermediate and capital goods industries that will be promoted. Barriers are therefore likely to be erected against capital goods imports around 2007.

REGIONAL TRADE INITIATIVES

The government's commitment to participation in regional trade arrangements (RTAs) is consistent with the proposed industrialization strategy.[19] The RTAs are considered important

[19] Regional trade is important for Kenya given that at the moment the region is the largest destination for Kenyan exports. Tanzania and Uganda alone are the largest destination of Kenya's exports accounting for 30%, while South Africa is the fourth largest source of Kenya's imports, accounting for 7.2%.

because "reduced trade barriers within Africa and enhanced trade-related infrastructure offer the greatest scope for the rapid growth of Kenya's manufactures and service exports" (Kenya 1996 p. 66). This is because the removal of tariff and non-tariff barriers among member countries of the RTAs will facilitate access to a wider market for Kenya's industrial exports, leading to exploitation of economies of scale and attraction of further foreign investment into the country.

Furthermore, by pooling resources for more efficient provision of industrial support services, these RTAs are expected to facilitate industrial development. Kenya's continued participation in RTAs such as the East African Community, COMESA, the Intergovernmental Authority on Development (IGAD), and the Cross Border Initiative (CBI) is aimed at securing these benefits. Further, to achieve the goal of a continent-wide single market, the government will press for rationalization of RTAs. Other measures will include supporting increased trade relations with other regional trade groupings such as South-East Asia and encouraging the manufacturing sector to exploit regional industrial support services so as to take advantage of available investment opportunities.[20]

To maximize benefits from the multilateral institutions in which the country is engaged, government officials participating in negotiations will need to improve their skills in negotiation and economic diplomacy.[21] In addition, ministries engaged in the

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[20] The policy of gaining access through RTAs will require that there is a reciprocal access to Kenya's markets, which seems to contradict the policy of raising barriers in 2007 to protect domestic intermediate and capital good industries.

[21] Currently, according to the plan, Kenyan interests during multilateral negotiations are not fully addressed due to inadequate

preparation of country position papers for such negotiations will be encouraged to coordinate their activities.

EXPORT PROMOTION INCENTIVES

Export promotion incentives act as a partial offset to the inherent anti-export bias in economies, such as Kenya's, that have partially liberalized trade regimes. These incentives that compensate domestic producers by making their exports more competitive are only valid theoretically until domestic resistance to full import liberalization, which necessitated them, has been overcome.[22] By pledging to maintain and even extend beyond the manufacturing sector such incentives as export processing zones (EPZs), manufacturing under bond, and VAT–duty drawback schemes, policy-makers may have either foreseen continued opposition to full liberalization or deliberately undertaken a policy of subsidizing exports.

Although the government is opposed to offering an export credit guarantee scheme to insure against the special risks faced by small-scale exporters, it will commit resources to relieve the infrastructure impediments to investment in the EPZ. Manufacturing firms setting up in the EPZ require industrial space and ready-made buildings as well as onsite infrastructure,

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economic diplomacy and negotiation skills (see for example Kenya 1997 pp. 203–204).

[22] To the extent that opposition to full import liberalization persists and tariffs are maintained to protect domestic industries competing with imports, exporting firms may be forced to use locally available inputs that may be more expensive or of a lower quality than the desired imports. This acts as a disincentive to exporting firms that are forced to use them. Export subsidies, of which the export promotion incentives are an example, should therefore serve to make the trade regime more neutral until such a time that trade is completely liberalized.

which the private sector is presently unwilling to provide due to the high cost of credit (Kenya 1996b p. 198). This acts as a subsidy to the few exporting firms in the EPZ, yet the success of the industrialization policy hinges on the maturation of small- and medium-scale enterprises to become exporting firms.

Additional support pledged to institutions such as the Export Promotion Council seeks to increase public and private sector cooperation in export promotion, with the main objective of identifying new export opportunities and expanding Kenyan presence in traditional and new markets during the plan period. Together with other stakeholders in the private sector, the Export Promotion Council will also establish an export-targeting system for direct and indirect exports and formulate a COMESA plan of action to develop export markets in the region. In addition, action will be taken to remove the bureaucratic delays in the Export Promotion Programmes Office, charged with monitoring the various tariffs, taxes and regulatory structures that affect exports.

2.3 Industrial policies

Industrial policies are conventionally directed at developing and encouraging certain industries and developing countries justify them by the widespread existence of market "failures", which work against the development of industry in these countries. Indeed, policy advice to governments in developing countries, presently dominated by neoclassical thinking, justifies industrial policy only on these grounds. Some of the main sources of market failure that would invite government intervention include the following.[23]

- ***Weak or non-existent markets*** make price signals

[23] The discussion on market failures is derived from Stiglitz (1996).

inappropriate for resource allocation and therefore require government intervention to support and nurture them. For example where capital markets are weak or non-existent, governments may establish development banks to mobilize long term savings for industrial projects.

- ***Technological spillovers*** make it difficult for private firms to appropriate the returns to acquiring knowledge and therefore reduce incentives for firms to invest in the production and acquisition of technology. Indeed, firms in developing countries that need to upgrade their technologies through acquisition and adaptation of foreign technologies are faced with such a dilemma. They bear the full brunt of failure but must share their success with their competitors, often against their will.
- ***Marketing spillovers*** make firms reluctant to engage in market research to develop foreign markets. This is because their success will again be shared with their rivals—often against their will—without the latter investing any resources. Further, the potential benefits of any good reputation they acquire in foreign markets spill over to their rivals, who by merely coming from the same country receive a good reception for their products. This may justify government efforts to develop export markets for industrial goods.
- ***Returns to scale*** derive from the "infant industry" argument. In the presence of imperfect capital markets, increasing returns may restrict the growth of small firms, which can compete with their more established rivals only when they are able to lower their production costs through cumulative experience and bigger production capacities. Government intervention, therefore, protects these firms until they are able to gain adequate experience to enable them to lower their costs to those of their rivals. Their growth under protection is often a precursor to their penetrating export markets. However, in many cases infant

industries have failed to mature, as they become comfortable under the protection regime.

- ***Coordination failures*** exist, principally because the absence of markets in developing countries reduces the coordination role of the price mechanism. Governments, therefore, need to perform this role. For example, the profitability of a final good industry depends on the simultaneous presence of a reliable supply of inputs. But the profitability of producing these inputs depends on assured demand from a pre-existing final good industry. Unless the government steps in to coordinate their activities, so the argument goes, none of these industries would be set up. Although the presence of trade may relax some of these constraints, the local capacity to produce industrial inputs is essential for the profitability of final good industries, as geographical proximity would enable the inputs to be built to the exact specification of the manufacturers and reduce transportation costs. There is therefore a need for some sort of coordination to establish both final good and capital good industries. Further, significant resources beyond the capacity of individual entrepreneurs or financial institutions are required to set up these industries and thus require well-developed capital markets to share the risk. In the absence of such markets, government intervention is necessary.

Not all these market failures are fully addressed by the industrial policy proposed in the current policy framework. Nor is it clear whether the "failures" can be best addressed by the government.[24] Industrial policies in the present policy

[24] Too often those who advocate government intervention on account of market failures do not consider the fact that government failure is a reality that has crippled many developing economies. Further, firm strategy may address some of the "market failures"

framework seek to supplement trade and macroeconomic policies by increasing competitiveness at the firm and industry level, thereby encouraging industrial development in the desired direction. These policies include

- internal trade policies
- policies on sources and allocation of finance
- policies on location of industry
- technology policies
- policies that promote small enterprises

INTERNAL TRADE POLICIES

Domestic competition is important if firms are to become internationally competitive. In Kenya, competition is promoted by price decontrols, provision of reliable market information, and enforcement of the provisions of the Restrictive Practices and Monopolies Commissions Act of 1989, which will strengthen fair trading, facilitate economic competition and prohibit unfair market conduct.

SOURCES AND ALLOCATION OF FINANCE

Low and declining domestic and foreign savings frustrate the investment effort necessary for the success of the industrialization strategy. The poor savings performance is attributed to a non-conducive investment climate, unsound fiscal policy stance and financial sector weaknesses. The fiscal policy issues have been addressed in an earlier section. Financial sector weaknesses are mainly attributed to weaknesses in the

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without a need for government intervention. A case in point is the vertical integration in large-scale Kenyan industry to overcome the coordination failure. The way forward should therefore rely on market friendly government intervention.

banking sector, which as the dominant institution in the financial system is expected to mobilize savings and offer intermediation services.

To overcome the perceived reluctance or inability of the banking sector to perform this role, the following reforms are proposed:[25]

- raising banking sector efficiency through increasing competition, enforcing minimum service delivery standards and encouraging banks to adopt new efficiency-enhancing technologies
- increasing the capacity of local capital markets to serve both small and big investors and companies
- increasing the participation of small savers and investors in the financial system by encouraging banks to offer intermediation services to the informal sector and small savers; encouraging "thrift" savings institutions so as to increase accessibility of the financial system to more Kenyans; and using tax incentives to encourage banks to expand their rural branch networks
- relaxing the stringent capitalization requirements that presently keep indigenous entrepreneurs away from the banking sector and so deny indigenous small-scale industrialists access to finance from those who would be more sympathetic to their business ventures[26]

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[25] In many developing countries where banking is dominated by a few foreign banks, the banking sector normally prefers to engage in business with big modern, mostly foreign, corporations whose business they understand. Banks avoid small indigenous enterprises, partly because they do not understand their business and partly because lending to these businesses is considered unprofitable because of the high administration costs which they incur.

[26] This policy suggestion raises moral hazard and adverse selection issues, which are discussed in depth in section 3.

- raising efficiency of development finance institutions through restructuring to enable them to better perform their role of providing long-term funding for industry
- direct lending by the Central Bank to priority industrial projects
- reforming financial institutions such as the National Social Security Fund (NSSF) and the cooperative credit societies to finance industrial activities

LOCATION AND REGIONAL POLICY

A policy of industrial dispersion is implicit during the first phase of the strategy in the emphasis on resource-based, labour-intensive small- and medium-scale industries. Unlike in the past, where diverse instruments and incentives were used to achieve this policy objective, government intervention will be mainly restricted to providing infrastructure in major urban centres. But with time, it will include the poorly served areas. To reduce industry start-up costs and partly influence location of industry, local authorities will be strengthened to provide basic infrastructure and will be required to set aside land for industrial use as well as for the construction of industrial parks.

TECHNOLOGY DEVELOPMENT POLICY

The problems that hamper the development of local research and development (R&D) capacity include inadequate public funding for industrial R&D, inadequate private sector participation in R&D, poor staff retention in local R&D institutes, inadequate links between the public R&D institutions and the industrial sector, poor technological learning capacities and poor technological infrastructure.

Proposed strategies for dealing with these problems include

- offering incentives to the private sector to increase its funding and support for R&D activities
- increasing the proportion of total public research

expenditure allocations to industrial R&D and opening such funding to competition from both private and public research institutes
- improving domestic technological bargaining skills to improve domestic capacity to absorb and adapt foreign technology
- strengthening institutions and institutional frameworks relevant to industry associations, training centres, standards institutes, technology support bodies and relevant legal bodies
- evolving a technology culture by encouraging technical training, possibly up to the university level
- increasing the links between public sector research institutions and the private sector so as to increase the application of their research output in the domestic industrial sector.

RELATIVE ROLE OF LARGE AND SMALL ENTERPRISES

The first phase in the current industrialization programme will promote small- and medium-scale enterprises that have strong links with the agricultural sector and that use relatively simple and labour-intensive technologies, which will increase the employment impact of industry. Once infrastructural and other constraints have been overcome, large-scale intermediate and capital goods industries will be promoted in the second phase. The policy framework paper considers the two types of industries as complementary in nature and offers different incentives to each, depending on the phase of industrialization.

2.4 Infrastructure development policies

The policy framework attributes the poor state of infrastructure to four factors: 1) rapid population growth, 2) limited financial resources for repair and maintenance, 3) poor management capacity, and 4) corruption in awarding and supervising infrastructure projects. In the short term, policy will therefore focus

on improving the quality and efficiency of operation of existing infrastructure facilities. Over the long run, new facilities will be provided to currently disadvantaged areas that have potential for industrial development.

The key infrastructure facilities necessary for industrial development are transport, energy, communications, water and sanitation, and land.

TRANSPORT

Infrastructure in the transport sector has steadily deteriorated over the past decade and a half, but the condition of this sector has become critical only during the last two years. Current policies to address this issue mainly aim at increasing the operational efficiency of facilities through restructuring the relevant institutions and focusing government expenditure on maintenance and rehabilitation rather than developing new facilities. For example:

- Road management will be improved by establishing an Executive Roads Management Board to manage the Roads Maintenance Levy Fund.
- Efficiency of urban transport will be increased by giving local authorities a share of the Roads Maintenance Levy Fund revenues raised in the areas of their jurisdiction.
- Kenya Railways will be restructured to increase efficiency by, among other things, signing a performance contract with the government.
- Capacity and efficiency of ports operations will be improved through restructuring the Kenya Ports Authority.
- The quality and efficiency of airport services will be increased through purchasing new equipment and improving the maintenance of existing equipment.

ENERGY

Measures to revitalize the energy sector include

- commissioning new power projects and restructuring the power sector through, for example, separating the generation and the distribution functions and establishing a regulatory authority to improve the supply of electricity
- divesting the Kenya Pipeline Company as an efficiency-enhancing measure
- encouraging efficient exploitation of fuelwood and solar and wind energy to boost the supply of sustainable energy

COMMUNICATIONS

Increasing the supply and efficiency of telephone services and the coverage of postal services will be achieved through, among other things, splitting the old Kenya Posts and Telecommunications Corporation.

WATER AND SANITATION

Budgetary and managerial constraints to providing water will be overcome by revising tariff structures and implementing a public investment plan for water supply services.

LAND

To influence industrial location, serviced land for industry will be provided through reviving the Estate Development Fund, enforcing the provisions of the Physical Planning Act of 1996 and encouraging local authorities to set aside land for use as industrial parks so as to reduce the set-up costs for industrial investors.

2.5 Human resource development policies

The human resource development policies outlined in the present policy framework offer particular measures that will "promote human resources through education, training, employment creation, population, health . . . all of which form

the basis for enhancing and utilizing the productive capacity of the country's manpower" (Kenya 1997, p. 130). The strategies for human resource development include population, education, training of workforce, and reform of wage guidelines and redundancy regulations.

POPULATION

Improving the health status of children and mothers as well as educational opportunities for young girls will reinforce the emerging demographic transition.

EDUCATION

Efforts to revitalize the education sector to support industrialization include

- increasing the participation rates at the pre-primary level from 35 to 50%
- reallocating funds to primary school level from other levels of education and dedicating these funds for acquiring books and equipment as well as for bursaries to the poor so as to increase access and boost completion rates from the present 47 to 70%
- reallocating secondary level subsidies to benefit the poor while targeting students from arid and semi-arid regions with specific programmes to boost enrolment; improving the teaching of science
- increasing funding to the Higher Education Loans Board in addition to improving working conditions for university staff and upgrading laboratories and workshops
- over the long term, reviewing the current education system to incorporate entrepreneurial training at all levels

TRAINING OF WORKFORCE

Policies to address shortcomings in training of a skilled workforce for industry include encouraging on-the-job training,

increasing the private sector's role in government training institutes, increasing government funding to training institutions and offering postgraduate conversion courses to science graduates to increase the number of technologists.

REFORM OF WAGE GUIDELINES AND REDUNDANCY REGULATIONS

Wage guidelines will be scrapped to increase the flexibility of labour markets in wage determination. The restrictive and cumbersome regulations governing redundancy declarations by firms will also be dismantled and replaced by an industrial relations system that promotes flexibility and rewards productivity. Further, reducing the wage gap between the private and public sectors will stop the loss of experienced workforce to the private sector.

2.6 Institutional development framework

To enhance implementation through increased partnership between the private and the public sectors an institutional support framework has been proposed covering market development, investment promotion, establishment of a National Industrial Development council and improving the socio-political environment.

INSTITUTIONAL FRAMEWORK FOR MARKET DEVELOPMENT

Three institutional support policies have been proposed to encourage market development. First, the country's embassies and missions abroad will be used to facilitate the penetration of export markets. Second, the government and the private sector will support financial market development for industrialization. Third, the government in collaboration with private sector stakeholders will use trade development officers and commercial attaches as well as the Export Promotion Council's trade information network to undertake market research in domestic

and external markets to increase access to domestic and external markets.

INVESTMENT PROMOTION

The following investment promotion policies will be pursued:

- An investment code will be enacted to streamline investment approval procedures and incentive packages.
- Trade and investment offices, opened in carefully selected countries, will be used to attract both portfolio and foreign direct investment resources.
- The Investment Promotion Centre will be strengthened to improve its effectiveness in advising potential investors on issues of technology transfer and subcontracting between foreign firms and local enterprises, and its efficiency will be raised to international standards to shorten the investment approval process.
- An industrial development levy will be established to fund these increased investment promotion activities.

NATIONAL INDUSTRIAL DEVELOPMENT COUNCIL

The National Industrial Development Council, to be established through the Industrial Development Act, will provide the institutional framework necessary for implementation of the proposed policies. With membership and funding drawn from private as well as public sector organizations, the council is expected to help in designing and formulating suitable policies for rapid industrialization. Its functions will include assisting the government in formulating strategies for the development of industrial subsystems, monitoring changes in market structure and advising accordingly, and ensuring that there is a level playing field for all in the industrial sector.

SOCIO-POLITICAL ENVIRONMENT FOR INVESTMENT

To enhance good governance, law and order and security the following actions are proposed:

- reducing corruption and its disruptive effects through *legal reform* to clarify rules and regulations, *civil service reform* to reduce the capacity and incentives for civil servants to be corrupt, and *budgetary reform* to limit abuses related to public revenues and expenditures
- improving the judicial system by increasing efficiency in the attorney general's chambers and the judiciary through automation and improved practices
- enhancing the effectiveness of the police force in crime prevention by improving communications between the police and the public and by equipping and training the police force

3 Critique of the policy framework

The current industrialization strategy is the most ambitious yet by the government. It consists broadly of a comprehensive infrastructure development programme as well as specific incentives aimed at inducing investment in certain core industries. Below we highlight weaknesses in the overall industrialization strategy as well as specific weaknesses in the incentive framework.

3.1 Weaknesses in the overall industrialization strategy

There are four outstanding areas of weakness in the overall industrialization strategy:

- Overreliance on the government to pick winners, as happened in Korea and Taiwan, without considering if the same preconditions exist in Kenya. Two preconditions that

ensured success in Korea and Taiwan were a *skilled labour force* and a *relatively high degree of income equality. T*he first precondition made possible the creation of an efficient civil service with a good implementation record. The second ensured that civil servants were able to operate free of pressure-group politics and negated the need for government redistribution policies that would have been inimical to investment and growth. This strategy of picking winners also seems to be too interventionist and does not have enough faith in the private sector.

- Failure of the strategy to highlight the link between the industries promoted in each of the two stages of the strategy. This may lead to underutilization of the industries encouraged in the second stage, because the substantial economies of scale necessary for the second stage industries and their subsequent need for a local market before developing competitiveness for the export market require coordination between the industries promoted in the two stages.
- Failure to undertake simultaneous improvement of agriculture, yet this is crucial for the success of the industrial sector. As Kenya is predominantly an agricultural country, the bulk of the industries will be agro-based. The development of the agricultural sector to provide the necessary raw materials such as cotton for textiles, hides and skins for leather industries, and industrial and beverage crops for processing industries will therefore be a necessary prerequisite.
- Failure to consider the responses of actual and potential competitors. The move towards free trade and regional integration could require Kenya to take into account developments in other countries, particularly in the COMESA region.
- Other weaknesses in the overall strategy include failure to consider the plausibility of achieving the necessary levels of savings and investment; absence of the financial resources and

capacity to implement all the proposals; failure to assess the impact of the policies on the cost structure of production; and failure to adequately and realistically address institutional weaknesses such as insecure property rights, lack of contract enforcement and corruption in the judiciary, which presently are serious hindrances to both local and foreign investors.

3.2 Critique of specific policies

3.2.1 Incentive framework

Here we raise several questions on the efficacy of incentive packages (comprising trade and industrial policies) in achieving the goal of export-oriented industrialization.

TRADE POLICY REGIME

Inadequate export promotion measures. The export promotion incentive framework is inadequate on at least three counts:

- It fails to consider the link between the achievement of international competitiveness and the penetration of export markets. Consequently, it pays insufficient attention to issues of cost structure and product quality, which are crucial to becoming competitive.
- Some of the proposed export promotion measures such as the VAT–duty drawback scheme require superior organizational capacity, which may presently be unavailable in the civil service.
- Failure by the government to consider offering an export insurance scheme to exporting firms may be counterproductive given the risk aversion of the owners of small- and medium-scale enterprises—a characteristic that has been identified as impeding their growth. Penetrating export markets is risky, and traditional measures that increase competitiveness may fail to bring about a sufficient response

in export supply if exporters are not adequately compensated for the increased risks of exporting.

Regional integration initiative. The regional integration initiative may be jeopardized in the short term by opposition to trade diversion from Kenya's less industrialized regional partners. Further, the success of the COMESA strategy relies heavily on the continued absence of South Africa from the regional trade arrangement.

Policy credibility. To secure the expected response from the private sector, policies should be clear, unambiguous and consistent. The policy framework fails to achieve this in some respects:

- The proposed two-phase industrialization strategy implies a reversal in the second phase of the trade liberalization measures undertaken in the first phase, and it thus reduces the credibility of the trade liberalization initiative.[27] The likely private sector response to this would lead to balance of payment problems, inflation and reduced savings. Further, investors may suspend investment in the export sector, although it is presently profitable, if they anticipate a reversal of policies in the second phase. Therefore, incentives to encourage industrialization in the second phase may harm the long-term prospects for success of industries encouraged in the first phase.
- Macro incompatibility is likely because the fiscal implications of phase two will clash with the government's stated desire to maintain a balanced budget and achieve a surplus. Investor response may subsequently be distorted.

[27] This falls under the well-researched time-consistency problems highlighted (and analysed for past failed trade liberalization episodes in Kenya) by Reinnika (1996).

INDUSTRIAL POLICIES

Sources and allocation of finance. The proposed solutions to easing the finance constraint facing small- and medium-scale enterprises are inadequate for a number of reasons.

- Advocating lower capitalization requirements for indigenous bankers, ostensibly to increase funding to small- and medium-scale enterprises, amounts to a credit subsidy to the small-scale enterprises. Further, due to "moral hazard" and "adverse selection" this policy is bound to result in more bank failures
- Direct lending by the Central Bank to priority industrial projects is clearly *not* a viable policy. This is because the considerable screening and monitoring skills required for such a task may not be resident at the Central Bank, which has a comparative advantage in regulation. It may also compromise the neutrality of the Central Bank, by making it hostage to vested interests.
- The policy response to inadequate savings tends to focus, to the exclusion of other important factors, on increasing public savings and solving institutional weaknesses in the financial sector that presently hamper private saving.
- Failure to consider some important characteristics of foreign direct investment (FDI) may undermine the employment creation and poverty eradication objectives of industrialization. For example, FDI usually adopts the capital-intensive production techniques that are prevalent in Western countries, which reduces their employment impact and negates the need to encourage small-scale enterprises. To attract South-East Asian FDI and get it to migrate to Kenya, the government may have to make additional concessions, because South-East Asia uses very labour-intensive techniques, and productivity levels of Kenyan labour may be too low. Further, FDI is more likely to prefer urban locations to rural because of the superior infrastructure facilities in the

former. Joint ventures between foreign and domestic firms may be encouraged by providing the domestic firms with regional infrastructure and finance support.

Regional dispersion. The present policy framework has no intention of immediately changing the current regional concentration of industries, although such a step would be important to create political peace and mobilize the entire nation behind the industrialization objective. Other inconsistencies and issues that need to be addressed follow:

- Providing water to rural consumers at a subsidized rate will implicitly subsidize industries locating there. Without a proper cost–benefit analysis, it may be impossible to justify the negative financial implications of such a subsidy to rural local authorities that provide the water systems.
- Widespread regional inequality may make the apparently rational policy of concentrating infrastructure in certain urban areas politically infeasible. Increased poverty levels in the rural areas may weaken the resolve of the government to concentrate infrastructure in urban area. The need to achieve a political equilibrium on the issue of priorities for infrastructure provision for industrialization has never been greater.
- The policy also ignores the possibility that there will be a need to provide infrastructure more widely to open up areas with raw materials that are not near the urban centres. There is a potential conflict in that this may occasion the demise of local (rural) small- and medium-scale enterprises that will now have to face competition from products of bigger firms in the urban areas that may be superior.

3.2.2 Institutional challenges

Some institutions that are vital to the industrialization objective such as the National Industrial Development Council, the

Executive Roads Management Board and the civil service have organizational and other flaws that should be addressed to increase their effectiveness. Such institutions will need to focus on the most productive actions and leave out the rest for private sector provision.

3.2.3 Resource implications and trade-offs

The policy framework fails to consider some important trade-offs and conflicts, such as

- the conflict between the fiscal strategy required for sound macroeconomic management and the ability to provide additional incentives through increased expenditure or revenue forgone
- the conflict between concentrating complementary investment in high-potential areas (such as the Mombasa–Nairobi–Kisumu corridor) that is likely to achieve lower aggregate production costs and spreading resources among political constituencies
- the need to balance the competing interests of savers and borrowers
- the conflict between the interest of workers and those of employers
- the need to balance between subsidies and a well-functioning market economy
- the need to balance between faster economic growth and attaining national objectives of creating employment and alleviating poverty
- the potential conflict between a smaller public sector and more intervention

The present strategy does not consider these conflicts nor does it weight the costs and benefits of the proposed interventions.The result has been an overambitious programme, little of which has been implemented so far.

4 Conclusions and recommendations

In this paper, we set out to review the continuities and discontinuities of policies on industrialization since independence in the light of the current industrialization policy. What becomes clear is that the government has departed from its previous development strategy in which agriculture and industry were allowed to develop in tandem as sources of economic growth. The present policy framework considers industry as the leading sector for addressing the development challenges the country faces. It therefore proposes to provide selected industries at various stages of the industrialization programme with the support that will enable them to grow and become exporters of their products. The apparent failure in the strategy is the absence of a holistic approach that considers and addresses the constraints, conflicts and trade-offs facing producers in all sectors of the economy. Specific recommendations follow.

TRADE POLICY REGIME

More attention should be paid to the measures that will enable Kenyan firms to cut costs and become competitive.

- Competitiveness in the manufacturing sector could be promoted if the entry and exit regulations that presently limit the number of firms in manufacturing were reduced. For example, the prior requirements for approvals that the Investment Promotion Centre practices can be considerably relaxed if environmental safeguards are undertaken.
- Efficient provision of infrastructure would also reduce unit production costs

Export promotion measures can be improved:

- With merit recruitment and incentive packages to attract the best staff, an administrative enclave could be set up within the civil service to deal with the VAT–duty drawback scheme.[28]
- Adopting an incentive framework that is lighter in organization, like the manufacturing under bond scheme, would give qualifying firms access to rapid, well-targeted duty- and tax-free imported inputs.

A managed full-import liberalization programme would make export promotion measures unnecessary. This step would entail warning the protected firms of impending reforms and removing beforehand all the infrastructure bottlenecks that would make them less competitive.

The government would need to provide small- and medium-scale exporters with adequate safeguards to reduce the risks of exporting that might otherwise impede their penetrating export markets.

REGIONAL INTEGRATION

The country needs to take into consideration the developments in other countries in the region when it is setting its strategy for industrialization. A starting point would be to establish, within existing research institutes, a department charged with researching or collating research and data on developments in the region.

[28] For example, the Export Promotion Programmes Office could be incorporated in the Kenya Revenue Authority in a refined role to administer the drawback scheme.

POLICY CREDIBILITY

The two phases of industrialization should not be looked at in isolation but rather be closely linked to provide optimal investor response.

INDUSTRIAL POLICIES

- Credit subsidies can be provided more efficiently by linking them to objective criteria like export performance or channelling them through restructured development banks. This policy worked effectively to promote exports in South Korea and Taiwan.
- A more elaborate policy aimed at increasing savings should include a population policy, which will increase the savings rate by reducing the dependency ratio.
- A more effective policy for foreign direct investment should target it at minimum cost while taking into account the country's resource configurations.
- The monetary authorities should give incentives to private banks to undertake institutional financial innovation that will encourage group lending. This would help minimize the costs that presently constrain lending to small- and medium-scale enterprises.

REGIONAL DISPERSION

- A cost–benefit analysis is needed to justify the increased financial burden to rural local authorities of providing water subsidies to industries locating there.
- A cost–benefit analysis is also necessary to determine whether the cost of the demise of local small- and medium-scale enterprises due to opening up of rural areas will be outweighed by the greater access to raw materials for urban-based industries.

- National consensus is needed on the pattern of industrialization and the sacrifices necessary to achieve it as a goal.
- A rational physical development plan is needed to guide locational choices.

INSTITUTIONAL CHALLENGES

- Government arbitration may be necessary to resolve the distribution conflicts within the Executive Roads Management Board charged with administering the Roads Maintenance Levy Fund. Further, it may be necessary to clearly link road maintenance expenditure to the levies collected to minimize the possibility of abuse.
- The functional overlaps that exist between the bodies created to facilitate the industrialization process may hamper their effectiveness. Therefore, there is need to safeguard against creating bureaucracies.
- The actions proposed for the civil service should take into account the need to build capacity, which would require additional strategies such as providing incentives and training and setting up a proper and enforceable code of ethics. This is an important requirement for the program's success in supporting industrialization.

RESOURCE IMPLICATIONS AND TRADE-OFFS

The policy framework should take into account the conflicts and trade-offs of various polices and programmes through analysis that would involve the government and all stakeholders. This is a necessary prerequisite for the programme to succeed.

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