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POLICY MONITOR

Improving Public Policymaking for Economic Growth and Poverty Reduction

In this Issue

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Building and Construction Yet to Provide Impetus to Economic Recovery

The Kenyan economy is projected to have grown by 1.8 percent in 2003 compared to a growth of 1.1 percent in 2002. The better performance for the year resulted from an improvement in some of the key determinants of investment climate. These determinants supported a slight positive recovery of business investment, which had registered negative growth in 2001 and 2002. Business investments are projected to have grown by 3.4 percent in 2003. The main contributing sectors to better economic performance are telecommunications and agriculture. The expected contribution of building and construction failed to materialize. The telecommunications sector grew by more than 35 percent in 2003, mainly in the mobile phones sub-sector. Overall, transport, storage, and communication grew by 9 percent in 2003. This growth is expected to continue in 2004 as a third mobile operator enters the market and competition continues to drive prices down. The agricultural sector is projected to have grown by 1.8 percent in 2003. This growth was driven mainly by better than expected performance in coffee. Other sub-sectors that achieved positive production growth are tea and horticulture. The maize sub-sector in the Rift Valley and Western Provinces performed well during the long rains and compensated for the poor harvests of the short rains in parts of Eastern, Central and Coast Provinces. The current maize shortage in the country may however be due to change in direction in cross-border trade from Kenya to Tanzania.

Exports are projected to have grown by 5% in 2003. Most of the exports were agricultural, especially coffee and horticultural products, which performed better than expected. While tea production increased slightly, tea exports declined slightly. There was also an improved performance of manufactured exports.

The positive growth in exports militated against depressed consumer spending, which remained flat throughout the year, underscoring the importance of an export-led strategy in the face of slackened domestic demand. Kenya's industrial sector appears to have been able to compete at the regional level as indicated by improved growth of other exports. The performance of the tourism sector in 2002 was more or less maintained in 2003, indicating that travel advisories did not have a catastrophic effect as was originally expected.

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Editorial

It is our pleasure to welcome you, our dear readers, to the second issue of the *KIPPRA Policy Monitor*. Reading through this issue, the reader will no doubt agree that the Institute had a challenging but very successful quarter. As the Executive Director notes in his message, the Institute was actively involved in planning and organizing the National Investment Conference. Secondly, the Institute was, within a very short duration, able to carry out, on request by the Ministry of Education, Science and Technology, a study on terms and conditions of service for academic staff in Kenya's public universities. These were very involving undertakings that required full mobilization of the resources of the Institute. In addition to these achievements, the first group of the Institute's young professionals completed their one-year training and some of them have already secured employment in various organizations.

This issue highlights more on the activities carried out in the Institute between September and December 2003. It also gives an overview of economic performance and a new economic forecast. Forecasts indicate that the economy will grow by 3% in 2004. The expected contribution of building and construction to economic recovery did not materialize in 2003 but telecommunications and agriculture stepped in to contribute to improved economic performance.

There are two interesting feature articles in this issue. The first article on Kenya's potential output and output gap and the implications on fiscal and monetary policies confirms the widely held view that Kenya's economy is performing below its potential. The second article discusses the role the private sector can play in provision and financing of infrastructure in Kenya.

We wish to acknowledge the very useful feedback we have received from readers of the inaugural issue of the *KIPPRA Policy Monitor*. The comments are very encouraging and will be considered in preparing our work activities and to improve this channel of communication. Continue sending your comments and views to *monitor@kippra.or.ke* or through the Institute's other channels of communication.

The Kenya Institute for Public Policy Research and Analysis (KIPPRA) is an autonomous institute whose primary mission is to provide quality public policy advice to the Government of Kenya by conducting objective research and analysis, and through capacity building in order to contribute to the achievement of national development goals. KIPPRA serves as a centralized source from which the government and the private sector can obtain information and advice on public policy issues.

KIPPRA acknowledges generous support from the European Union (EU), the African Capacity Building Foundation (ACBF), the United States Agency for International Development (USAID), the Department for International Development of the United Kingdom (DfID), International Development Research Centre (IDRC), the Government of Kenya, among other development partners and organisations.

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Like the building and construction sector which had been expected to play a critical role in economic recovery, the manufacturing sector did not live to expectations and remained subdued in 2003 mainly due to stagnant consumer spending. Households' consumption of products such as grain mill products, cigarettes, beer, tyres, and metal products registered negative growth. The performance of the manufacturing sector is projected to have been 0.7 percent. This minimal growth was supported mainly by the ability of the domestic industrial sector to penetrate the regional market. A key sub-sector of manufacturing that performed well in 2003 is motor vehicle assembly, which experienced a major turn-around as a result of investment incentives provided by the Government. The sub-sector grew by 15 percent. Other manufacturing sub-sectors that performed well include cement production and dairy products, which grew by 11 and 15 percent, respectively. Production of soft drinks continued to grow rapidly during the year, registering 18 percent growth following price reduction by major players in the industry.

Outlook for 2004: Investments and Consumer Spending Critical to Continued Recovery

The economy is forecast to grow by around 3 percent in 2004, driven mainly by investments in both the public and private sector. This will be supported by modest recovery in consumer spending as employment-related to infrastructure reconstruction begins to pick up. Exports are projected to reach a real growth of between 5-6 percent. External inflows for budget and balance of payments support, together with flows for project financing are expected to provide support for the shilling throughout the year as the international community honor the pledges made at the Consultative Group meeting. Import demand is expected to pick up at a slightly lower speed than inflows of external resources, occasioning a possible slight appreciation of the shilling but at a rate consistent with the forecast real growth in exports.

In order to realize the forecast growth in 2004, it will be important to maintain the trend towards a reduction in government consumption. The share of government consumption in total GDP is projected to have fallen from 32.7 percent in 2002 to 31.9 percent in 2003. This trend is expected to continue such that the share will be 30.3 percent in 2004. It is expected that restructuring of government budget will allow the share of government investments in GDP to increase from 2.4 percent in 2002 through 3.1 percent in 2003, rising to 4.9 percent in 2004. Another important requirement for this growth to be realized is that long-term interest rates will fall below 14 percent for business investment in 2004. The release of the Bank Rate by the Central Bank is likely to help in achieving this pre-requisite.

Private consumption remained flat in 2003. Unless income and consumption tax reform measures are considered as part of providing consumer spending impetus, it is expected that modest recovery for 2004 will only come from realization of increased employment due to infrastructure works expected in the year. However, there is a case for tax cuts if there will be improved tax administration. The proposed cuts are expected to lead to a faster recovery in consumer spending to enable the manufacturing sector achieve faster and higher growth rates in 2004 and beyond.

Performance of Kenya's economy: 2003-2004

GDP components	Real growth rates (%)		
	2002	2003	2004
	Provisional	*Forecast*	*Forecast*
GDP at market Prices	1.0	1.8	3.0
Exports	5.0	6.6	5.4
Imports	-16.7	3.6	7.7
Government consumption	4.3	-0.6	2.3
Private consumption	-13.7	0.2	1.9
Gross investments	-1.8	7.8	21.7
Private sector	-0.4	3.8	13.3
Public sector	-9.7	31.9	61.0

Source: KIPPRA Forecast

Government budget underpinning economic forecast

Central government revenue (Ksh millions)	2002	2003	2004	2005
Taxes on income and profits	61.303	71.035	79,513	85.968
Value-added tax	53.503	56.400	58.415	61.307
Excise duties	33.860	38.735	41.524	43.869
Other taxes and licenses	1.305	1.438	1.568	1.678
Taxes on international trade	23.621	23.769	24.685	26.423
Non-tax revenue	33.293	34.845	40.610	45.113
Foreign grants	10.896	20.969	39.387	20.325
Total revenue and grants	***217,781***	***247,191***	***285,702***	***284,683***
Central government expenditures (Ksh millions)				
Wages and allowances	81.888	87.526	99.276	99.262
Other goods and services	62.942	73.155	77.441	79.726
Domestic interest	25.256	21.323	22.363	27.228
Foreign interest	7.550	6.281	5.071	7.777
Subsidies and transfers	36.874	36.894	38.842	40.524
Development expenditure and net lending	35.099	43.096	62.331	71.525
Total expenditure and net lending	***249,609***	***268,275***	***305,324***	***326,042***

Source: KIPPRA Forecast

From the Executive Director

Dr. Hezron Omare Nyangito
Ag. Executive Director

The last quarter of the year 2003 witnessed two outstanding activities undertaken by the Institute. The Institute significantly participated in supporting the National Investment Conference organized by the Ministry of Planning and National Development. The Institute also undertook a study on terms and conditions of service for university academic staff on request from the Ministry of Education, Science and Technology. The study was aimed at forestalling brain drain in Kenya's public universities.

The National Investment Conference, which was opened by the President of Kenya, provided a forum for government and private sector to discuss the national investment programme developed from the *Economic Recovery Strategy for Wealth and Employment Creation*. The Institute provided the link between the government and the private sector, and recorded the proceedings of the conference in order to prepare the final report.

The study on terms and conditions of service for university academic staff was done amid a national crisis in public universities after academic staff in all public universities in Kenya withdrew their services and went on strike. In conducting the study, KIPPRA tried to maintain its objectivity in policy research and analysis, and in advising the government. The comparative methodology applied in the study was premised on the idea that it is incentives that determine the supply of labour (in this case academic and research labour). For that reason, forestalling brain drain would have to be approached from a competitiveness aspect. The key question then was whether Kenyan public universities are competitive enough in attracting and retaining highly skilled academic and research staff.

Another key achievement of the Institute during the quarter was the successful completion of the first internship programme for young scholars wishing to make a career in policy research and analysis. Nine young scholars have completed their training and joined the research world.

On institutional development, I am pleased to report that the African Capacity Building Foundation (ACBF) has approved a second phase grant of US$ 1.7 million to the Institute. The grant was signed on 1 November 2003 at the ACBF Headquarters in Harare, Zimbabwe. Dr. Sousmana Sako, Executive Secretary of ACBF signed on behalf of ACBF while Mr. David S. O. Nalo, Permanent Secretary, Ministry of Planning and National Development signed on behalf of the Government of Kenya. Members of the ACBF delegation who attended the signing ceremony included Dr. Appollinaire Ndorukwigira, Program Leader Zone I; Dr. Edwin Forlemu, Manager Legal Services and Special Assistant to the Executive Secretary; and Mrs. Grace Banya, Programme Officer, East and Southern Africa. On the Kenyan side were Dr. Hezron Nyangito, Acting Executive Director, KIPPRA; Mr. D.M. Maina, Assistant Secretary, Ministry of Finance; Ms. Bernadette Njoroge, Legal Counsel,

Education Minister, Prof. George Saitoti (left) receives a report on lecturers' proposed salaries from the KIPPRA Acting Director, Dr. Hezron Nyangito, at Jogoo House, Nairobi

AGs Chambers; and Dr. G.O. Maroko, Counsel/Head of Chancery, Kenya High Commission, Zimbabwe.

The Institute also received project-based funds from the International Development Research Center (IDRC) for two projects, namely: Analyzing the Kenyan economic and political transition with a focus on the strategies outlined in the *Economic Recovery Strategy for Wealth and Employment Creation*; and institutional support on the Regional Programme for Enterprise Development (RPED). The United Nations Environment Programme (UNEP) also approved US$ 50,000 for development of a training toolkit for use in the project on Economic Incentives (EIs) for environmental and natural resource management.

Kenya's Potential Output and Output Gap: Implications for Fiscal and Monetary Policies

Stephen N. Karingi, Mwangi S. Kimenyi, and Angelica Njuguna
Macroeconomics Division, KIPPRA

Introduction

One of the Government of Kenya's policy objectives is to put in place sound macroeconomic policies to achieve economic and social targets. Fiscal and monetary policies are two instruments, among others, whose design has a critical bearing on the performance of the economy. A key consideration of the stance of monetary and fiscal policies that the Government should put in place is the potential output of the economy and, by implication, the output gap.

Potential output is the maximum output the economy can sustain without generating a rise in inflation. Output gap on the other hand is the difference between the actual economic output and the nation's output potential. This gap is an important benchmark for assessing inflationary or disinflation pressures in the economy. Measuring the level of the economy's potential output and output gap therefore helps in identifying sustainable non-inflationary growth and in assessing the most appropriate macroeconomic policies, specifically the most appropriate fiscal and monetary policies.

When actual output is more than the potential output, the economy is said to be operating above its capacity–in essence the aggregate demand exceeds aggregate supply. This situation is often a source of inflation. The appropriate policy responses are monetary and fiscal policies that ease the demand. Reducing government spending for instance and/or raising taxes are examples of fiscal policies to deal with excess demand. On the other hand, monetary policy response for dealing with excess demand would be a tightening of monetary policy such as raising interest rates. When the actual output of the economy is below its potential, the appropriate short-term response is to ease monetary and fiscal policies since the risk of generating inflation is low. In the medium to long-term however, other policies can be put in place to address the supply-side constraints that limit the economy's actual growth reaching its potential.

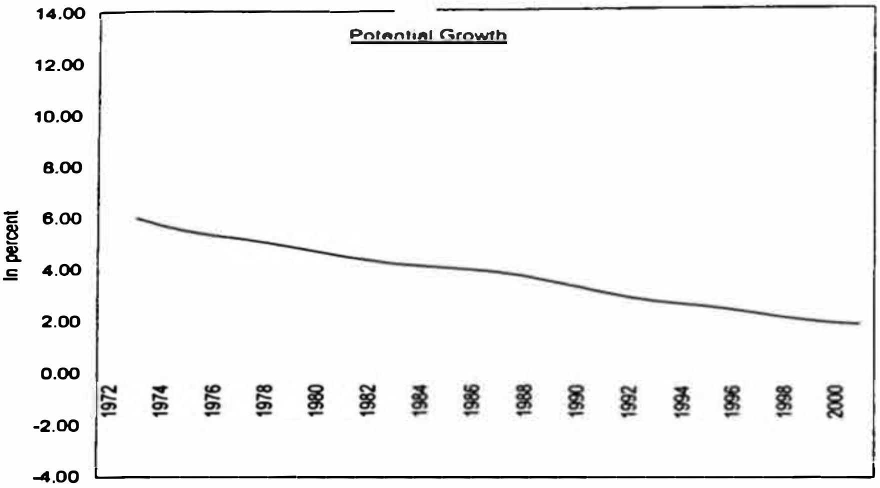
Measures of potential output and output gap are also used in determining structural measures of policy targets such as budget deficits. When the economy's actual output is above its potential, the budget balance will be more positive as a result of higher revenues. In a downturn, the budget balance is more negative as a result of lower growth of revenues. The output gap is therefore useful in establishing the real budget balance that should form the basis for policy response as it allows the budget balance to be cyclically adjusted.

Measuring Kenya's Output Potential and Output Gap

Measurement of output potential and output gap involves decomposition of output into its permanent (the trend), and the temporary or cyclical components. The permanent component represents the economy's potential output. Several methods are used to measure potential output and output gap and are categorized into two main classes. The first category uses statistical techniques while the second category is based on economic theory. The most popular statistical technique is a filtering method developed by Hodrick and Prescott but only published in 1997. The other statistical methods build on earlier work by Beveridge and Nelson first published in 1981. The techniques that are based on economic theory involve estimation of a production function for the economy. The theory-based techniques also make use of time-series methods, which consider relationships between various economic series that are related to output. Nonetheless, it is generally accepted that none of these methods is completely satisfactory, and each method has advantages and disadvantages.

Growth in potential output in the Kenyan economy has been declining since the early 1970's

Results of many studies in developed countries and economies in Asia and Latin America have arrived at different measures of potential output and output gap from different methods applied to a given country. In this study, both statistical and theory-based techniques were used to estimate Kenya's potential output and output gap for the period between 1973 and 2001. The specific techniques used in estimation are the Hodrick-Prescott method, Univariate Beveridge Nelson method, Multivariate Beveridge Nelson Method, Vector Autoregression method, and the Production Function method.



Due to declining output potential growth of the economy over the years, the output potential is not as large as one might think

The estimated potential output and output gap for Kenya vary depending on the method used. Nevertheless, the results reveal broad consistency between all measures in the following aspects:

◆ *Kenya's declining output potential*

All the methods used indicate that growth in potential output in the Kenyan economy has been declining since the early 1970's. Therefore, the results provide a broad consensus on the overall trend and performance of the Kenyan economy. The figure above shows a declining trend in measured potential output based on the Hodrick-Prescott filter method. A similar trend is observed from the simplest of measures, which uses the linear trend of the economy's growth performance as the measure of potential output. The consistency of the results in regard to declining potential output are indicative of capital destruction in most of the period covered by the study and stagnation of joint productivity of labour and capital in the economy.

The table on the right provides a detailed summary of actual and measured potential output growth of the Kenyan economy between 1973 and 2001. The results show that the method used notwithstanding, the potential output of the economy has been declining.

◆ *Consistent negative output gap*

The study results also confirm the widely held view by economists that the performance of the Kenyan economy is below its potential. There was a broad degree of consistency from all methods in terms of the sign and the size of the output gap as shown in the figure below. While this study has confirmed the existence of negative output gap, it does however raise an important issue that most analysts tend to ignore. That is, due to declining output potential growth of the economy over the years, the output potential is not as large as one might think. This is an important result with major implications on the extent to which expansionary fiscal policy and a relaxed monetary policy can be used in the short term to steer the economy towards its potential output growth rates.

◆ *Stagnation of multifactor productivity*

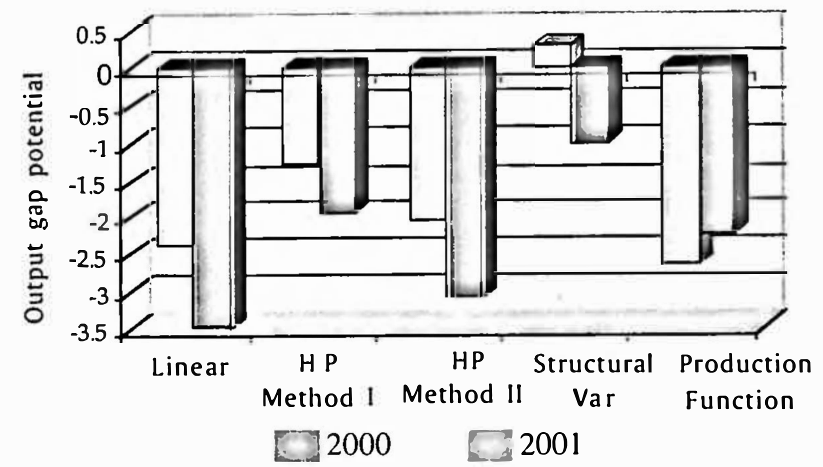
One of the methods used in this study involved estimation of an aggregate production function of the

Actual and Potential Output: Five-Year Average Growth (%)

Year	Actual	Alternative Measurements of Potential Output by Method					
		Linear	HP Method	B N Method UBN	B N Method MBN	Structural VAR	Production function
1973-75	2.97	6.32	5.73	1.56	0.06	3.70	7.21
1976-80	5.82	5.20	5.03	6.42	6.19	6.25	5.51
1981-85	3.58	4.12	4.28	4.33	3.81	2.63	4.86
1986-90	4.97	3.42	3.72	4.36	4.76	5.43	2.67
1991-95	2.13	2.92	2.82	2.67	2.68	1.62	3.70
1996-00	1.99	2.55	2.18	0.84	1.68	2.61	2.35
2001	1.20	2.36	1.88	4.65	1.22	-0.79	0.77

HP=Hodrick-Prescott; UBN = Univariate Beveridge Nelson method; MBN= Multivariate Beveridge Nelson method; VAR = Vector Autoregression method

Negative Output Gap of the Kenyan Economy



Total factor productivity has been contributing very little to economic growth and its growth has been declining in the last decade

Kenyan economy which not only allows determining of shares of labour and capital in output but also the productivity of these two factors. The study showed that the labour share of income is around 0.75 and that of capital is approximately 0.25. In regard to growth, the most important estimates are those of total factor productivity of capital and labour, which captures the contribution to growth of technological advances. In simple terms, total factor productivity when viewed with respect to a factor such as labour shows the output per worker. This study has found that total factor productivity has been contributing very little to economic growth and its growth has been declining in the last decade.

Implications for monetary and fiscal policy

Monetary and fiscal policies are key elements of Kenya's *Economic Recovery Strategy for Wealth and Employment Creation* (ERSWEC) currently being implemented through the Investment Programme of the ERSWEC. The Budget Statement delivered on 12 June 2003 included economic policies that are in line with the strategic direction set out in the Economic Recovery Strategy. The implications of the findings of this study on monetary and fiscal policies are presented below.

◆ *How loose should monetary policy be and what is the implication for the bank rate?*

As already noted, potential output and output gap measurements are an integral part of monetary policy formulation. Indeed, in countries where inflation targeting framework is used, the output gap is one of the most important determinant of how loose or tight monetary policy should be for inflation target to be achieved at maximum growth. In the Kenyan situation, while an inflation targeting framework is not used by the Central Bank, current efforts to develop a neutral benchmark for interest rates (the Bank Rate) makes estimation of Kenya's output gap important. This is precisely because the Bank Rate should take into consideration the economy's output gap and the difference between observed inflation and the targeted inflation. Due to the uncertainty that prevails in measurement of output gap, it is important to add that monetary authorities in Kenya would be expected to use additional information. Application of 'gut-feeling' or informed hunch is an accepted practice all over the world especially where data is a problem.

The estimated output gap indicates that actual output is below the economy's potential. This means that to stimulate growth, there is room to relax monetary policy without necessarily creating inflationary pressures. Nevertheless, the extent to which a loose monetary policy can be used to stimulate growth is rather limited because of steady decline in potential output, which in essence has resulted in a lower output gap than would have

The extent to which a loose monetary policy can be used to stimulate growth is rather limited because of steady decline in potential output, which in essence has resulted in a lower output gap than would have otherwise been expected

otherwise been expected. The negative output gap is around 2.5% of potential output, much lower than the extensive excess capacity that is thought to exist.

As for the bank rate, the output gap that has been established in this study implies that interest rates need to be lower than where they have been in line with a looser monetary policy. However, serious work needs to be done in setting the Bank Rate with respect to output gap. Measuring output gap should not be based on one method alone. If output gap is overestimated and consequently a much looser monetary policy pursued (through a lower than would otherwise be the case Bank Rate) then inflation can easily become a problem. On the other hand, if output gap is underestimated such that a tight monetary policy is put in place, there is possibility that growth impetus would be reduced. For Central Bank of Kenya not to be seen to be reckless in the case of an overestimated output gap or hindering growth in a situation of an underestimated gap, it is important that there is consensus on the best measure of output gap in the economy at any one time, in addition to other factors that determine the Bank Rate.

The output gap estimated suggests that there is room for Government to run a budget deficit without fear of creating inflationary pressures. However, an expansionary fiscal policy should take into account the declining potential output growth that the economy has been experiencing, which suggests that there is limited scope for increasing budget deficit

◆ *Budget deficit yes but a word of caution*

The other important implication of the findings of this study is to do with budget deficit. Just like in monetary policy, the output gap estimated suggests that there is room for Government to run a budget deficit without fear of creating inflationary pressures. However, an expansionary fiscal policy should take into account the declining potential output growth that the economy has been experiencing, which suggests that there is limited scope for increasing budget deficit. Consequently, and because of the declining potential, it would be more appropriate if fiscal expansion was targeted at those expenditures that lead to an increase in the economy's long-term growth potential.

◆ *The case for structural reforms and why ERSWEC must be implemented*

It is clear that while there is room for use of expansionary fiscal and monetary policies, the scope for such policies is limited especially given the growth targets the Government has set in the Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC). This being the case, focus should be on structural issues that would reverse the declining growth of productivity in the economy. In particular, the recurring theme that the fiscal structure of government expenditure needs to be revisited is strengthened by the results in this study. The results favour higher spending on investments. Labour market reforms that would contribute towards increased labour productivity are also needed to address the stagnation in productivity of the economy. These structural measures, among others, are likely to bear more positive results than just relaxation of monetary policy where scope is limited by the narrower output gap. In short, soft options such as loosening monetary policy and pursuing fiscal expansion through consumption are not likely to achieve the growth targets in the ERSWEC. Major structural reforms as spelt out in the Economic Recovery Strategy for Wealth and Employment Creation, and in the Investment Programme of the strategy will need to be implemented for the economy to be on a sustainable recovery path. ❑

This article is based on a recent paper by Angelica E. Njuguna, Stephen N. Karingi and Mwangi Kimenyi of KIPPRA. The study on *Alternative Methodologies for Measuring Kenya's Potential Output and Output Gap* is published as KIPPRA Discussion Paper No. 28 of 2003

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Role of Private Sector in Infrastructure Provision and Financing in Kenya

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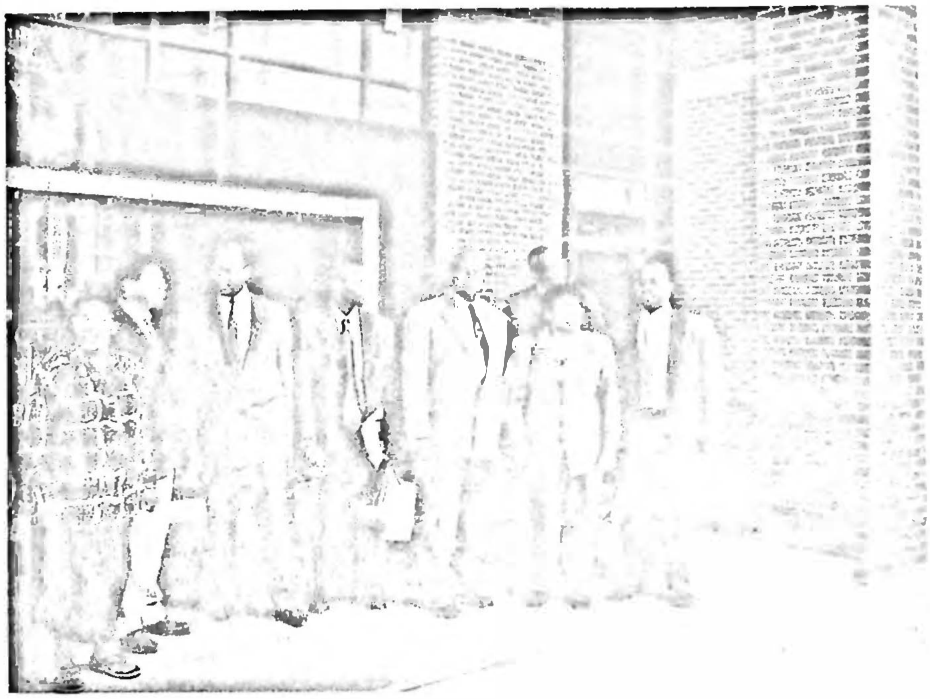
Infrastructure and the services thereof are the engine or the wheels of economic production. While government is expected to play a major role in provision of infrastructure, there is evidence that dominant and pervasive interventions by government have failed to promote efficiency or responsive delivery of infrastructure services in sub-Saharan Africa. Given that Kenya faces a daunting challenge of provision of infrastructure due to lack of adequate public sector resources, there is need for greater and better understanding of the role the private sector can play in effective and efficient delivery of infrastructure and services. Such understanding is necessary in developing the correct level and mix of infrastructure services for sustainable socio-economic growth.



Dr. Aligula (first on the right) and Mr Mwaura (third from left) of KIPPRA together with other members of the Transport Policy Committee during a recent tour of Malaysia to familiaze with the country's transport policy and development

Increasing participation of private sector in provision and financing of infrastructure services is now common all over the world. Governments are turning to the private sector to finance, build, operate, and transfer new oil and gas power plants, toll roads, telecommunications facilities, ports and airports. During the 1990s, there was rapid and widespread move by governments round the world to involve the private sector in provision and financing of infrastructure. Seeking private funds and managerial expertise to meet rapidly growing demands for modern energy, telecommunications, water and transport, developing countries saw investment of nearly US$ 755 billion in nearly 2,500 private infrastructure projects over the period 1990 to 2001. While South East Asian and Latin American nations have enjoyed large investments in infrastructure by the private sector, sub-Saharan Africa has attracted very little private sector financing, with exception of South Africa.

The Government of Kenya requires Ksh 203 billion in the next two and a half years to finance rehabilitation of the country s dilapidated infrastructure. Persistent budget deficits and reduced funding from development partners has precipitated a big financing and investment gap in infrastructure. The largest share of investment is expected to go to road transport, where Ksh 105 billion is required for improvement of over 4,000 kilometres of road. Water and sanitation, power, and railway transport would require Ksh 33 billion, Ksh 21 billion and Ksh 17 billion, respectively. However, of the total resource requirements, the Government will provide Ksh 51 billion while development partners are expected to provide Ksh 35 billion. It is expected that the private sector will step in to meet a financing gap of Ksh 117 billion.

There are various reasons for involvement of private sector in financing of infrastructure. The reasons can be as diverse as the countries but there are common reasons including the need to improve the efficiency of the utility providing public services by reducing inputs costs, increasing billing and collection, and adjusting tariffs to reflect production costs.

OPTIONS	ASPECT Asset ownership	Operations and maintenance	Capital investment	Bearer of commercial risk	Duration	Examples
Service Contract	Public/Private	Public/Private	Public	Public	1 - 2 Years	Chile (Santiago), India (Madras)
Management Contract	Public	Private	Public	Public	3 - 5 Years	Gaza, Trinidad and Tobago
Lease	Public	Private	Public	Shared	8 - 15 Years	Guinea , France, Senegal, Italy Spain, Poland
Build Operate Transfer	Private (bulk services)	Private	Private	Private	20 - 30 Years	Malaysia (Johor)Australia (Sydney)
Concession	Public	Private	Private	Private	25 - 30 Years	Argentina , Ivory Coast, Philippines, Venezuela, France, Spain, Macao
Divestiture	Private	Private	Private	Private	Indefinite	England and Wales

Source: Authors construct adapted from Cowen, Penelope (1997)

Also, governments may involve the private sector with a purpose of reducing the fiscal burden on the state, caused by deficit-ridden public utilities. Governments may also want to channel resources only in sectors where private sector involvement is not feasible, such as in public health and primary education, therefore leaving other sectors to the private sector.

While some of the objectives that a country sets for privatization fit into the general mould, there may be others that may need to be stated and actively pursued. In Malaysia for instance, one of the goals of privatization is to facilitate enhanced local participation in the country s economic activity. To this end, it is made clear that for any privatization, 30 percent is reserved for locals. The Malaysian government has set up a specific Ministry of Entrepreneurship Development, complete with mechanisms of accessing funding to enable locals acquire skills to actively participate in the provision of the nations supportive infrastructure and economic services.

Privatization generically means transfer of assets of a public entity including the shares in a state corporation, operational control of assets of a public entity and operations previously performed by a public entity to an entity other than to a public entity. A number of privatization options are available depending on the goals that the government wishes to achieve. Once the principle of private sector participation is invoked, there must be a careful consideration of various options *vis a vis* the country s strategic objectives.

Privatization Variants

- BOT (Build, Operate and Transfer): A company funds, constructs, owns and operates an infrastructure for a limited period (approximately 30 years), at the end of which the infrastructure is transferred at no charge to the concessioning authority.

- BOO (Build, Own and Operate): A company funds and constructs infrastructure, which it owns and operates for an unlimited period. A variation of this is the BOOT (Build, own, Operate, and Transfer) contract.

- Lease/Operate Contract: This differs from conventional concession in that infrastructure necessary for operation of the service is not constructed by the operator (lessee), but made available to the latter by the public authority, which is generally responsible for the funding of their project. The lessee, who therefore has exclusive responsibility for operating the service, obtains remuneration from the users, paying a fee to the

public authority designed to contribute to amortization of the authority s investments.

◆ Management/Corporatization Contract: This is an approach in which service delivery remains public, but in which managers are given greater responsibility and an arms length relationship to government. New Zealand and Chile are two examples of countries were this model has been implemented with success. While substantial efficiency gains are possible, these gains turn out to be difficult to sustain over time.

According to the Privatization Bill of the Government of Kenya, the method of privatization in Kenya may be any of the following:

◆ Public offering of shares concessions, leases, management contracts and other forms of public-private partnerships;

◆ Negotiated sales resulting from the exercise of pre-emptive rights;

◆ Sale of assets, including liquidation;

◆ Any other method approved by the Cabinet in the approval of a specific privatization proposal.

The Way Forward for Kenya

Involvement of the private sector in provision of infrastructure and services thereof must be carefully thought out. Lessons from countries that have privatized indicate that deliberate consideration must be made of fallback or renegotiation eventualities. The resultant legal, institutional, and regulatory environment must address key concerns of all players.

If the privatization of Kenya s infrastructure is to achieve goals that are beyond the immediate goals of fiscal fidelity, operational and commercial efficiency, then it is imperative that the country sets agreed and realistic objectives to be achieved from various privatization initiatives. Structures to support realization of these objectives, including passing of the Privatization Bill, need to be developed. The needs of the private sector must also be taken into account.

Privatization programmes that deny the need to make tradeoffs always end up making them badly, therefore opening the results up to unnecessary criticism. Further, experience has clearly shown that fair and effective safety nets can be implemented, and they are crucial to success of the privatization process. In Argentina railways, for example, the full commercial risk was transferred to the concessionaires. Governments should retain commercial capital risks only in cases where transfer of the risk to the private sector would be reasonably costly.

Finally, determined privatization in the right general direction is usually better than delay in the hope of perfect analysis or total consensus. This can be a difficult trade-off to make but while most mistakes can be fixed during the process, delay is usually irreparable. Great care should be taken to get the objectives, terms, and conditions of the contract document correct because bad contracts can never be enforced. At the same time, contracts should be drafted with emphasis on the conditions that would guide subsequent negotiations. Case studies have shown that developing economies and their legal systems are rarely predictable enough to permit rigid enforcement of concessioning agreements, and reasonable changes should be expected.

With a light touch!

Two economists were walking down the street when they noticed two women yelling across the street at each other from their apartment windows.
Of course they will never come to agreement, stated the first economist.
And why is that?, inquired his companion,
Why, of course, because they are arguing from different premises.

One day, a man walked into the main library of a major university. He stopped at the reference desk and asked the librarian if she had any current books about economics and the economy.
She answered that she did, and led the man to the reference shelves where the economics and economy books were.
To the surprise of both the librarian and the man, all the books were off the shelf being used.
"That's OK", the man said. "I will go to another library. You see, I'm a very busy man, and I set this weekend aside for studying economics and the economy."
The librarian said she understood and gave the man directions to the nearest research library. But her interest piqued, she asked: "Why are you so urgent to study economics and the economy?"
The man replied: "I'm an economist. I've been teaching at this university for the past ten years. I'm attending a business meeting on Monday, and I figure the economy has changed in the past ten years."

Two economists meet on the street. One inquires, "How's your wife?" The other responds, "Relative to what?"

Macroeconomics Division

The Division in collaboration with the Treasury and the Kenya Revenue Authority has now completed a study on fiscal architecture and revenue capacity for Kenya. The findings will have important implications on whether Kenya is an overtaxed country. Looking at tax compliance rates of all major taxes and the revenue potential for the future, the research points to tax administration rather than tax policy as the problem. The burden of taxation in Kenya can be more evenly distributed and tax rates lowered by raising compliance rates. The good news, therefore, is that with improved tax administration, Kenya's tax performance of 22 percent of GDP can be maintained.

The KIPPRA-Treasury Macro Model (KTMM) provides an instrument for consistent data-based forecasting rather than wild guesses. As preliminary data for last year continue being released, there is ample evidence that the performance of the tourism industry was not actually a disaster as widely expected.

One of the most exciting studies completed during the quarter is presented as a feature article in this issue. The study measured, through different methods, the potential output of Kenya's economy using data for the period 1972-2001. The implications are clear; expansionary policies are welcome both on the fiscal and monetary side but the room for expansion is not as large as often thought. Of concern is the finding that the output potential of Kenya's economy is declining, and therefore the need for higher investments.

Productive Sector Division

The Division began building a trade database during the quarter and also continued supporting the Ministry of Trade and Industry in developing country positions in ongoing trade negotiations.

The Division has prepared papers on trade in services as well as fisheries, and the benefits and costs of LOME Conventions. Work on the optimal geographical configuration of an EPA with the EU has also been completed. An inaugural newsletter of the Kenya Trade and Poverty Programme was also produced. In addition, the Division has been involved in preparing a Trade Policy Development Strategy Paper, Export Development Strategy Paper and a paper cataloging the various non-tariff barriers to trade and their impact on the economy.

The Division's work on micro and small enterprises (MSEs) has been ongoing especially in developing a curriculum for training policy analysts and implementers. Similarly, work on coordination of donor participation in the MSE sector is ongoing. A sector workshop will be held in late January.

Social Sector Division

The Division has remained very active in research in the areas of education and health sectors and on poverty and labour market. Research findings on the decline in primary school enrolment in Kenya, and on the effects of globalization on the labour market in Kenya were accepted for publication in internationally refereed journals. The paper on decline in primary school enrolment in Kenya has also been selected to compete for awards at the Global Development Network (GDN) conference to be held in India at the end of January 2004.

Research on the Public Expenditure Tracking Study on education, health and agriculture was completed. This was an exciting study jointly done with Macroeconomics Division of KIPPRA and various ministries. The study reveals minimal resource leakage between the ministry headquarters and facility level in the education sector. However, resource leakages were detected at the district and facility level, especially in the health sector. In agriculture, the study reveals that farmers training centres are under-utilized. The study also shows areas that require further research.

Current research priority in the Division is on HIV/AIDS and its impact on agricultural productivity and HIV/AIDS at the work place. Outputs of this research are likely to be completed in the next quarter. The Division is also doing some work on the contribution of the private education sector to various aspects, including enrolment, employment among others.

Infrastructure & Economic Services Division

The mission of the Division is to develop innovative, research-based infrastructure policy options and move them to the practical marketplace of policy-making and decision makers. The Division focuses on problems inhibiting the development and provision of physical infrastructure and services in energy, information and communications technology, petroleum transmission and distribution, solid waste management, transport, construction and housing, and environmental health.

The Division has been heavily involved in development of the Draft Green Paper on an Integrated National Transport Policy for Kenya. The contents of this document and the general policy direction espoused have been exhaustively discussed and adopted.

Private Sector Development Division

One of the key projects in the Division is the Umbrella Project for creating an enabling environment for improving business in Kenya. The project is funded by DfID and managed by KIPPRA. The main activities in the project involve analysis of policy, legal, regulatory and procedural impediments to creation and growth of businesses in Kenya. The project is structured into three components: Simplifying the Regulatory Environment for Business (SREB), Private Sector Advocacy (PSA), and capacity building in Government. The Institute implements the SREB and capacity building components while the Kenya Private Sector Alliance (KEPSA) implements the advocacy component

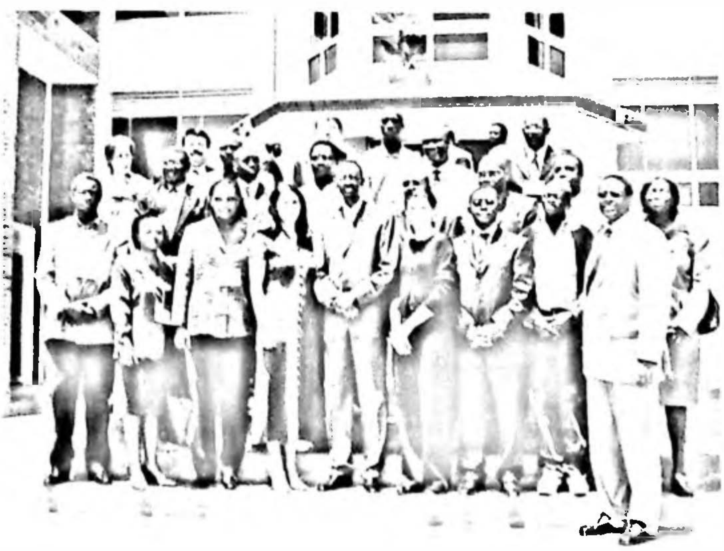
The SREB component is a research component that encompasses pro-active and responsive research activities targeting issues of concern as identified by the private sector. Among the issues being addressed include: trade licensing, financial services, land utilization, local authorities by-laws, macroeconomic policies, infrastructure and economic services, and social issues that impact on business operations.

The advocacy component aims to assist the private sector in advocating for policies that enable creation of a favourable environment for business and investment. Research outputs from the SREB component inform the policy advocacy. This component also supports capacity building in private sector associations.

The capacity building component aims to develop capacity in ministries and government regulatory agencies so that policy makers can respond to reform proposals made by the private sector and other stakeholders.

A steering committee formed in October 2003 comprises representation from various ministries and KIPPRA staff.

Three members of the committee attended a training programme in Rwanda on *Making Markets Work* in October 2003.



Dr. Rose Ngugi of KIPPRA (front-third from left) together with other participants, including President Kagame of Rwanda, during the training programme on Making Markets Work held at Kigali Institute of Science and Technology from 12-19 October, Rwanda. The course is developed and taught by the Havard School of Business

Quotable Quotes

Concepts without perceptions are empty; perceptions without concepts are blind.

Kant

Mathematics has no symbols for confused ideas.

George Stigler

Someone once said about partisan analysts that they use economic data the way a drunkard uses a lamppost: for support rather than illumination. Or as Disraeli put it, there are three kinds of lies: lies, damn lies, and statistics.

Paul Krugman

Young Professionals Training Programme

One of the Institute s major achievements during the October—December 2003 quarter was the graduation of the first group of Young Professionals (YPs). The Young Professionals Programme aims at equipping young economists with skills in research and policy analysis through a one-year hands on training. Besides taking lectures on selected courses, young scholars participate in rigorous public policy research and analysis under the Institute s senior researchers. Eight young professionals completed their training during the quarter. They are:

Infrastructure and Economic Services Division
- John M. Mutua
- Pauline M. Mwangi
- Omar Bundid Dar

Macroeconomics Division
- Anne Kamau
- Joseph Wambua

Productive Sector Division
- Jonathan Nzuma

Social Sector Division
- David Muthaka
- Diana Kimani
- Robert K. Nyaga

Some of the graduates have already been taken up at the Institute while others have found employment in such institutions as the Central Bank—a testimony to the quality of training they have received at KIPPRA.

The Institute is happy to welcome the second group of thirteen trainees. The trainees have been selected through a competitive process. About half of them are coming from the public sector.

Letters to the Editor

I wish to note that the areas of focus by the *KIPPRA Policy Monitor* do not include issues related to foreign policy and in particular security, regional and international cooperation. It is therefore important that research and policy analysis done by KIPPRA covers these areas in order to bring into mainstream of development issues of foreign policy as they now, more than before, feature prominently in regional and international cooperation. And multilateral trading arrangements.

Amb. Peter Ole Nkaruiya
Permanent Secretary, Ministry of Foreign Affairs

"Thank you very much for this unique initiative "The Policy Monitor". I commend KIPPRA and urge you to maintain its release as scheduled."

David S.O Nalo
Permanent Secretary, Ministry of Planning & National Development

Thank you for the KIPPRA Policy Monitor, we acknowledge the good work done therein.

Hon. Danson Mungatana
Assistant Minister, Ministry of Regional Development

From Divisions

Bittersweet Departures:The Macroeconomics Division had a bittersweet end of year. Two staff joined the Research Department of Central Bank of Kenya. These are Raphael Owino and Joseph Wambua. The Division is proud to have worked with the two economists. The Division is also proud that three other economists who received offers for employment at the Central Bank had passed through the Division. Yes! It is all in the spirit of capacity building for the nation.

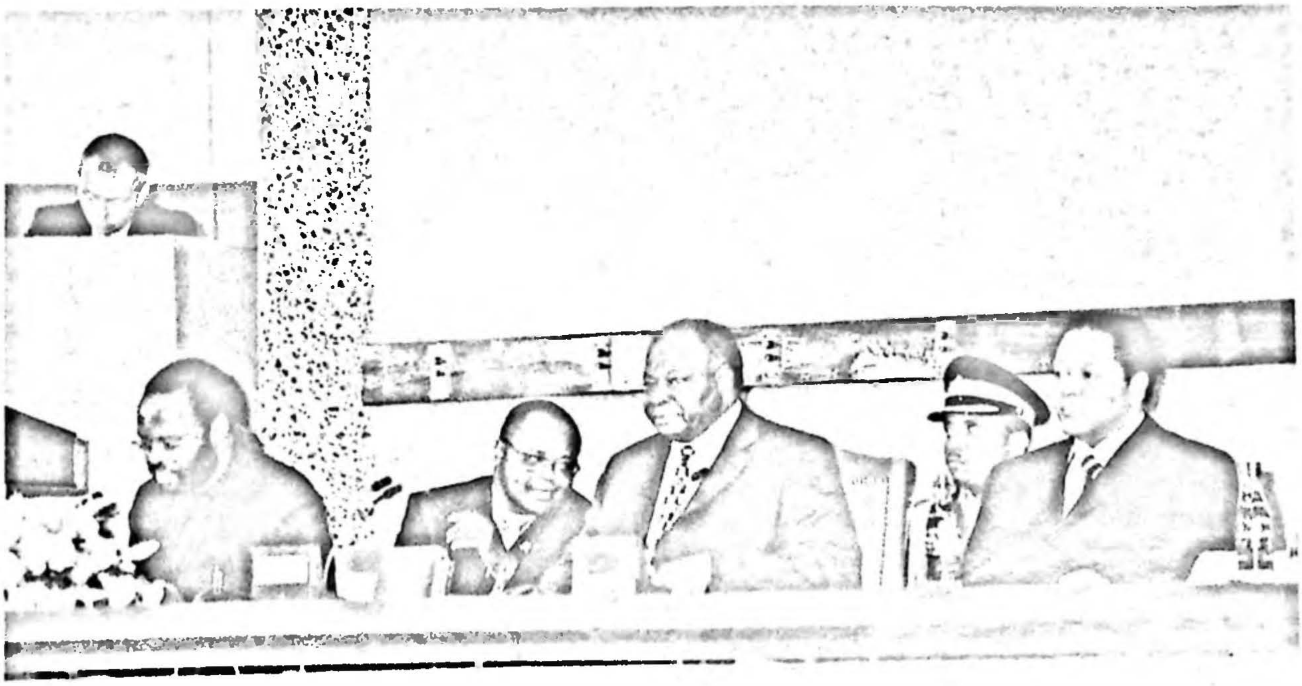
Good Progress by PhD Candidates: Jane Kiringai (University of Nottingham) and Moses Sichei (University of Pretoria) have completed their course work and are now preparing their PhD theses. Maureen Were (University of Dar es Salaam) and Lydia Ndirangu (University of Wagenigen) are also about to complete course work for their PhD studies. The Institute takes pride of the speed at which these these KIPPRA staff are pursuing their studies.

IFPRI 2020 Network/KIPPRA Workshop

The International Food Policy Research Institute (IFPRI) 2020 Netwotk and the Kenya Institute for Public Policy Research and Analysis (KIPPRA) organized a one day workshop on *Agricultural Policy and Impact on the Kenya Economy* on 4 November, 2003 in Nairobi. The following papers were presented during the workshop:

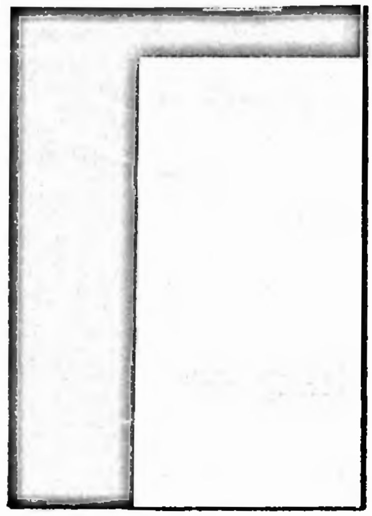
- *Effects of liberalizing trade on agriculture and its implications on poverty reduction in Kenya (Dr. S. Karingi, KIPPRA)*
- *Role of infrastructure and government policies in determining efficiency of Kenya s maize marketing system (Dr. T. Karugia)*
- *Animal health service delivery systems in Kenya s marginal areas under market liberalization: a case of community-based animal health (Dr. J. Omiti)*
- *Effects of land tenure on agricultural productivity and the environment: a case of Suba and Laikipia Districts (P.O. Obunde, Ministry of Agriculture)*
- *Rural household transitory food insecurity: bridging inter-seasonal food gaps in arid and semi-arid lands (M. Muyanga, Ministry of Planning and National Development)*

The workshop was attended by among others, Dr. Hezron Nyangito (2020 Vision Coordinator), Mr H. Mule (2020 Network Advisor), and Mr. J. K. Kinyua (Permanent Secretary, Ministry of Agriculture).

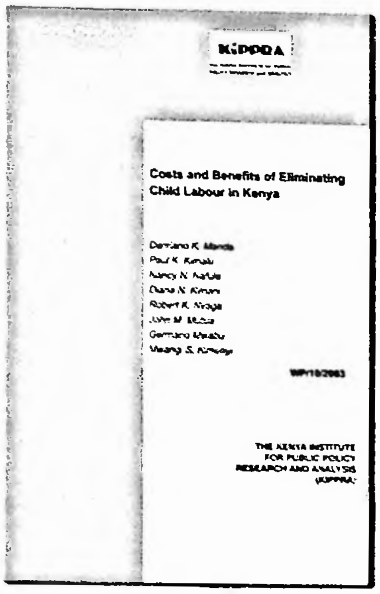


ABOVE: His Excellency President Mwai Kibaki (second left) opens the National Investment Conference. With him are Hon. Jeff Radebe (first left), the South African Minister for Public Enterprises; Hon. Prof. Peter Anyang' Nyong'o (first right), Kenya Minister for Planning and National Development; and Mr. David Nalo, Kenya Permanent Secretary, Ministry of Planning and National Development; BELOW: KIPPRA staff and other participants at the Investment Conference

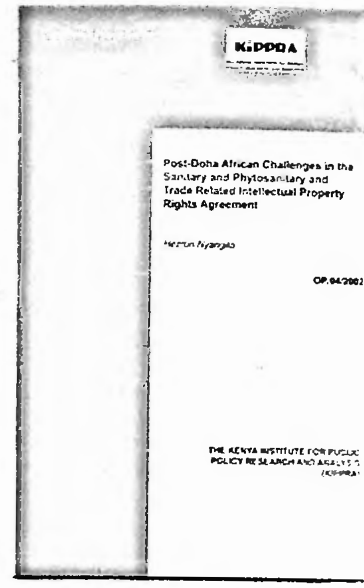
POLICY PAPERS



WORKING PAPERS

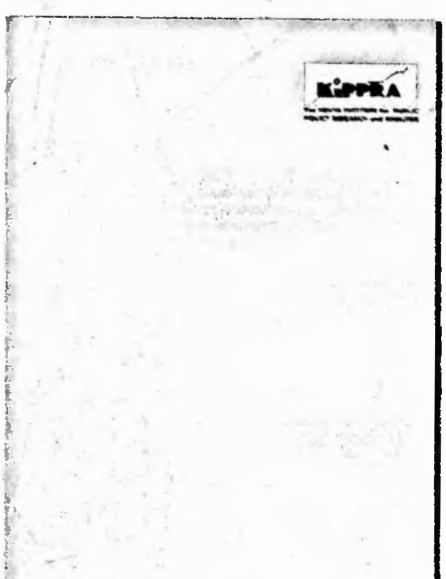


OCCASIONAL PAPERS



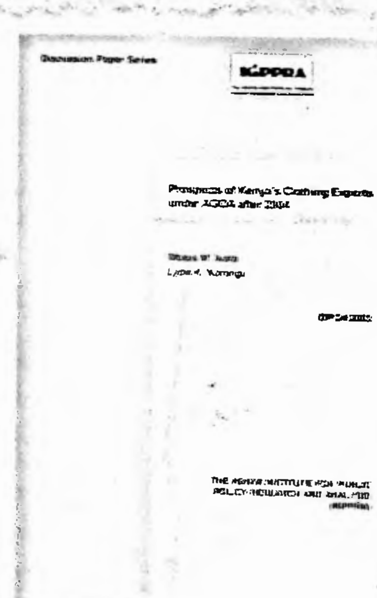
KIPPRA

PUBLICATIONS SERIES



CONFERENCE PROCEEDINGS

SPECIAL REPORTS



DISCUSSION PAPERS