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Thinking Policy Together

Enhancing the Effectiveness of Kenya's Institutional Framework for Export Trade Promotion

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Introduction

The size of Kenya's export trade has been shrinking over the last two decades. Despite the country's exports of goods and services averaging 20% of GDP in the last 20 years, the average share has fallen to 17.2% in the last 10 years before further shrinking to 13.9% in the last 5 years.

In stark contrast, the contribution of exports of goods and services to GDP for Uganda and Rwanda has risen to 14.9% and 18.4%, respectively, in the last 5 years up from 14.8% and 12.4%, respectively, in the last 20 years. This development may either mean that the trade sector in these East African Community (EAC) countries is expanding faster than other sectors, or other sectors in Kenya are expanding faster than the trade sector.

The average contribution of export trade to Kenya's GDP also lags that of Sub-Saharan Africa (SSA) (29.2%), Middle East and North Africa (MENA) (44.5%), Organization for Economic Cooperation and Development (OECD) (26.2%), and the European Union (EU) (41.0%) over the same period. Enhancing the effectiveness of Kenya's institutional framework could support expansion of the trade sector for enhanced contribution to development.

Existing research has shown that trade drives growth and development. Indeed, countries that provide incentives to the trade sector grow and develop faster by exporting more. As a result, promoting export trade could drive Kenya's development as enshrined in the Kenya Vision 2030.

A country's institutional framework is a key factor that influences performance of the trade sector. This policy brief examines how Kenya's institutional framework could support expansion of the country's trade sector for faster development. Focus is accorded to the role access to trade finance, court system, tax inspections and associated bribes, operating licenses and permits, on-the-job training of employees, quality certification, competition from informal enterprises, and customs and trade regulations play in promoting export trade.

Kenya's Institutional Framework and Export Trade

Access to trade finance

Access to trade finance promotes exports. It erodes market-entry barriers as exporting firms meet storage and transport costs with ease. It facilitates bulk purchase of tradeable goods and services, and bulk storage and transportation for optimal enjoyment of economies of scale . Majority of exporting firms in Kenya (52.0%) have access to credit compared to 48.0% without access. The high cost of credit is a challenge among firms without access to trade finance. 87.2% of exporting firms secure trade financing from private commercial banks, 10.3% from state-owned banks or state agencies, and 2.6% from other types of financial institutions.

Liquidity problems hinder entry of firms into export market as they lower the probability of being able to finance sunk costs. Further, liquidity constraints enhance the likelihood of firms exiting the export market due to inability to meet recurring costs . 31.7% of the exporting firms report access to trade finance as not an obstacle to operations, 40.5% report access to trade finance to be a moderate obstacle to operations, while 27.9% report access to trade finance to be a major obstacle to operations. Evidence shows that for every firm that secures a line of credit or loan with a financial institution, the share of direct exports in total sales is likely to increase by 0.1 percentage points, on average, compared to what would happen if credit was inaccessible.

Quality certification

Internationally recognized quality certifications grow exports. 31.2% of the firms have internationally recognized quality certification labels on exported goods. Certifications nudge consumers to have confidence and trust that exported goods and services are compliant to internationally recognized safety and quality standards. Assurance that exported goods comply to international safety and quality standards promotes export trade. Firms with internationally recognized quality certification witness a 0.2 percentage points rise in the share of direct exports in total sales. Possession of internationally recognized quality certification therefore promotes export trade. Firms with the certifications gain trust and confidence from consumers in foreign markets that exported goods and services have conformed to internationally recognized safety and quality standards and do not pose health and environmental risks.

The effect of the enhanced confidence and trust on exported goods and services is increased demand, which fosters export trade. The major types of quality certifications possessed by exporting firms include ISO 9000:2015, which ensures providers of training and assessment of quality of exported goods and services conforms to international standards, FSSC 22000 which certifies exported food stuff have met international standards, HACCP which promotes food safety through analysis and control of chemical, physical, and biological hazards right from raw material production, procurement and handling, manufacturing, distribution and consumption of final goods and services, ISO 9000 dealing with quality management, ISO 9001:2015 which demonstrates goods and services meet customer, statutory and regulatory requirements, ISO 14001:2015 and ISO 207 demonstrating conformity to environmental management, and United Nations Global Compact demonstrating adoption of sustainable policies.

Tax inspections

Majority of firms that export goods and services in Kenya get inspected for tax compliance at least 3 times and at most 46 times in a year. Normally, tax inspections are expected to improve tax compliance. They may, however, disrupt operations for firms and create avenue for bribes. The latter lowers productivity and raises operational costs. Evidence shows that over 25.4% of exporting firms give bribes when visited by tax inspectors. Firms may have incentive to offer bribes if the additional cost of doing so is lower than the cost of paying the taxes, or the fines and fees that would be imposed for non-compliance. This, however, is unsustainable in the long-run. For every tax inspection visit by tax officials, the share of direct exports in total sales is likely to shrink by an average of 0.02 percentage points.

The evidence indicates that the frequency of tax inspections shrinks exports. Inspections are carried out to assess compliance to the existing tax disclosure requirements. Time spent with tax officials during tax inspections is time that could have been spent in undertaking trade transactions or enhancing operational efficiency for improved firm performance in export trade. They create bureaucratic inefficiency, which adversely affects export trade. Inspections are a form of bureaucracy that ends up straining operations of firms, with adverse effects manifesting in shrinking exports. Inspections create incentives for bribes which consequently shrink sales . Enhancing the effectiveness of tax administration in the country could enhance export trade.

On-job-training

On-the-job training enhances worker skills, morale, productivity, earnings, and enhances self-regulation, which consequently enhances

export trade as an economic activity . It also enhances managerial efficiency through instituting internal controls, processes, and procedures to mitigate institutional risks. Higher employee productivity is key in promoting export trade.

Evidence shows that firms undertaking employee training witness 0.11 percentage points growth in the share of exports in total sales. For Kenya, 42.3% of the firms undertake on-the-job training for full-time and permanent employees. On-job-training should be prioritized as a contributor to specialization and export competitiveness.

Court system

By enforcing explicitly agreed upon contractual terms, the court system plays an important role in either incentivizing or disincentivizing participation in export activity. An effective judiciary creates certainty against breach of trade contracts. This certainty promotes export trade. The evidence shows that if the court system is effective, then the share of exports in total sales grows by 0.03 percentage points.

However, lengthy court process, coupled with incidences of bribes, increase costs incurred by firms and could make export activity unattractive. These additional costs are highly likely to make export activity unattractive, especially among micro, small, and medium enterprises (MSMEs). To enhance the effectiveness of the Kenyan court system, effort should be directed at reducing turnaround time for determination of cases, improving transparency and cost of litigation, and eradicating bureaucracy and corruption as 66.7% of the exporting firms report that the Kenyan court system is a hindrance to export activity.

Operating licenses and permits

Since export activity is highly formal, a regulatory environment that supports firms to easily start exporting while lowering the likelihood of exiting the export market is important in encouraging participation in export activity, especially among MSMEs. Bureaucratic inefficiency may, however, slow down the distribution of trade permits and operating licenses. The evidence corroborates this observation in that over 70.0% of exporting firms perceive business licenses and permits to be an obstacle to operations.

For Kenya, delays in securing operating licenses reduce the share of exports in total sales by 0.03 percentage points while bottlenecks in accessing trade permits reduce the share of exports in total sales by 0.04 percentage points. Enhanced facilitation to access trade permits and licenses, expansion of the existing automated platforms for accessing the permits and licenses, and improvement of awareness creation among MSMEs on procedures and processes for accessing the licenses and permits could support formalization while expanding the country's tax base.

Competition from informal enterprises

Rigid regulations are likely to nudge firms to operate informally as a way of enhancing cost efficiency. The evidence shows that 78.7% of exporting firms perceive practices of competitors in the informal sector to be an obstacle to operations. More specifically, actions of competitors in the informal sector reduce exports by 0.1 percentage points.

Firms operating informally may have a competitive advantage in that they do not incur marginal costs associated with cumbersome regulatory framework. When consumers are unable to distinguish between goods and services from formal enterprises from those from informal entities, then actions of competitors in the informal sector could potentially drive formal enterprises out of business.

Customs and trade regulations

Customs and trade regulations play an important role in regulating goods and services, including labour that passes customs boundary of exporting or importing country. Kenyan firms are likely to export less if the destination market has higher regulatory burden. The evidence shows that 80.0% of the exporting firms perceive customs and trade regulations to be a barrier to export trade.

However, if less rigid and cumbersome, customs and trade regulations could increase exports by 0.2 percentage points. Targeted efforts towards trade facilitation, cooperation in quality management and assurance, and strengthening of institutional links for information exchange especially among MSMEs could improve Kenya's export competitiveness.

Policy Implications

Capacity: Firms have incentive to engage in bribery to expedite securing of operating licenses for exported goods and services when responsible institutions are inefficient. Institutions mandated with undertaking customs clearance and issuance of operating licenses should strengthen and expand the existing digital platforms to support capacity for effectively and efficiently executing custom clearance and license issuance requests. They should institute internal self-regulation mechanisms through good institutional governance and creation of institutional policies against bribery.

Regulatory reforms: Actions of competitors in the informal sector shrink export trade. Firms are likely to operate informally to enhance cost efficiency if the existing regulatory framework is rigid and cumbersome. There is need to review the country's regulatory framework as relates to export trade to enhance coherence and eradicate overlaps and rigidities. Reforms in the country's customs and trade regulations coupled with trade facilitation support, for instance, could enhance access to foreign markets for Kenyan goods, services, and labour.

National quality infrastructure: Internationally recognized quality certifications foster export trade. There is need to entrench Kenya's quality infrastructure in a unified policy to enhance institutional coordination in provision of quality services as regards standards, certification, conformity assessment, and market surveillance. As such, the country should undertake to develop and finalize a National Quality Infrastructure Policy.

Self-regulation: There is need to invest towards nurturing a national and organizational culture of acceptable morals, values, virtues, and customs as the foundation for formal institutions. Through trainings, managerial experience and employee compliance to best work ethics could be enhanced, with the outcome being reduced institutional risk for export trade promotion.

About KIPPRA Policy Briefs

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

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