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Improving public policy making for economic growth and poverty reduction

Options for Sustaining Kenya's Economic Growth Pattern

Achieving sustainable economic growth in Kenya has continued to be elusive. Economic growth has been characterized by episodes of both high growth rates (1960s, 1970s and after 2003 to present) and recession (around 2000 with a negative growth rate). Also, the dual nature of the economy has become more pronounced, with the informal sector growing faster than the formal sector. Looking at sectoral performance, the share of agriculture and manufacturing in value added has declined over time, while private services have gained prominence. A review of the economic policy priorities for achieving economic growth reveals that there has not been a significant shift in sectoral priorities over time. As the economy continues on its recovery path from the recession experienced in 2000, it is important to establish what could have gone wrong with Kenya's past growth efforts, and also determine which sectors have the capacity to contribute significantly to economic growth.

Economic Growth Outcomes

Kenya's development agenda immediately after independence emphasized stimulation of demand for goods and services as a way of generating economic growth. The desired production mix was to be determined while considering the exploitation of available markets and conservation of scarce resources (mainly capital, high-level manpower and foreign exchange) while making use of abundant ones (unskilled labour and land). Major emphasis was on manufacturing, agriculture, trade and services. Increased production from manufacturing depended on the growth of domestic demand and import substitution. Agriculture, on the other hand, depended on increased use of fertile land through irrigation and reclamation, and also increased productivity. Increase in agricultural output primarily targeted export markets, while increase in manufacturing was more heavily directed towards satisfying domestic demand, largely through import substitution. Industrial priorities were evaluated according to a set of criteria, which included: export or import substitution potential; contribution of value added within Kenya; high labour-capital ratio (given the surplus labour and scarcity of capital); production of investment goods for self-sustaining growth; and contribution to the diversification of the economy to reduce risk due to fluctuations.

In the early 1970s, the World Bank formulated sectoral priorities that were to ensure efficient operation of the economy for more growth, employment creation and increased generation and distribution of income. The proposed strategy was to increase the flow of resources towards productive sectors, which inevitably would lead to reduction in the growth of infrastructure and social services. The priority productive sectors were considered as agriculture and manufacturing, with the

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most immediate priority being towards agriculture. Agriculture was considered a priority mainly because it was already viewed as an efficient user of resources. Increasing agricultural productivity was considered an effective way of tackling poverty. The manufacturing sector was expected to contribute to growth, but with substantial reforms in terms of efficiency, which required a policy change from import-substitution to resource-based export industries and promotion of small-scale industries.

Deliberate efforts were made in the 1990s to promote linkages among industries and sectors to enhance the spread effects of industrial growth and to facilitate the transfer of technology, skills and growth. There was further need to adopt an industrial culture and an export mentality. Between 1997 and 2001 emphasis was on expansion and modernization of existing industries and on the attraction of new investments in light manufacturing and resource-based industries. This choice of industries followed the approach by the East and South-East Asian newly-industrialized countries' initial industrialization path, which focused on agro-processing, food processing and light manufacturing such as textiles and clothing, leather and leather goods, food, beverages and tobacco.

The government's blueprint for economic recovery, the Economic Recovery Strategy for Wealth and Employment Creation (2003-2007), recognizes the critical productive sectors as agriculture, industry and tourism. The need for sound macroeconomic management in achieving faster economic growth has also been underscored in the strategy. Emphasis has been on ensuring stable exchange rates and fiscal stability, in addition to reducing risks and inefficiency in the financial sector, encouraging long-term financial instruments, and reducing domestic debt.

A look at the past growth performance and sources of growth reveals several issues.

The country has not taken advantage of the abundant factor of production (labour). This has implications on the achievement of the objective of employment generation and also on achieving sustainable economic growth and development.

Declining labour share in factors of production

Labour as a share of total factors of production decreased over time while capital ratio increased, which implies that the economy has became more capital-intensive. The changing structure depicts technological advancement and use of cheap labour. However, the incremental capital output ratio, which gives the units of capital required to produce a unit of output and an indicator of efficiency of resource use increased from 2.4 in 1966 to 13.9 in the 1990s. This means that capital became more inefficient over time. According to the theory of comparative advantage, a country should derive comparative advantage from the more abundant factor of production—for Kenya, labour. The country has, therefore, not taken advantage of the abundant factor of production (labour). This has implications on the achievement of the objective of employment generation and also on achieving sustainable economic growth and development.

Sectoral contribution to value added

The share of agriculture in total value added significantly declined from 41.8 percent in 1976 to 26.4 percent in 2003. On the contrary, the share of private services in total value added significantly increased from 26.2 percent in 1976 to 37.2 percent in 2003, becoming the dominant sector in 2000. The increase in private services value added was mainly in financial services, and transport and communication. The positive performance of financial services was due to the policies that have been pursued over time, which ensured increased demand for financial services. Growth in the transport and communication sector was mainly because of increased internet use, wider telecommunication coverage, etc. However, these sectors have become more capital-intensive, which implies that they use more capital and less labour as compared to 1976. For instance, labour contributed 75 percent of financial services value added in 1976, as compared to only 37 percent in 2003. In addition, labour contributed 68 percent of transport and communication value added in 1976, but accounted for about 39 percent in 2003. This partly explains why the economy has experienced growth with fewer employment synergies given that the sectors that are driving the economy are more capital-intensive. The question that arises is whether service-led growth is sustainable given the economy's level of development.

Decomposition of output growth

Structural decomposition of output growth reveals that final demand was the major source of growth between 1976 and 2003, contributing about 59 percent of total gross output. 92 percent of final demand was household consumption, with minimal contribution from investment and government consumption. However, analysis also shows that the household share in earnings from labour and capital declined because of the declining share of labour in value added, which has implications on the efforts to reduce poverty. The second largest contributor to output growth was intermediate consumption, which contributed about 49 percent of total output growth. This expansion in intermediate demand is a positive sign of technological change. However, the increased intermediate consumption was met through increased import intensity, which weakens inter-sectoral linkages that are crucial for growth. Export demand contributed 14 percent of output growth while import substitution did not contribute to output growth between 1976 and 2003. Decomposition at sectoral level reveals that the manufacturing sector contributed the largest percentage of output growth, contributing about 29 percent of total output growth, followed by agriculture (14%), trade, hotels & restaurants (13%) and transport & communication (12%). This shows that manufacturing and agriculture were the major sources of growth between 1976 and 2003.

Openness

Kenya has become a more open economy, even though the share of imports in gross output increased significantly while the share of exports declined. Kenya's development strategy has been predicated on export-led growth but exports have not emerged as the key driver for growth, an outcome of both external and internal factors. In addition, a look at the structure of exports and imports shows that the industrial sector has been a net importer while agriculture has been a net exporter. In 1976, imports into industry accounted for 78 percent of total imports but only 32 percent of total exports, as compared to 75 percent of total imports and 47 percent of total exports in 2003. Agriculture, on the other hand, accounted for 5 percent of total imports and 33 percent of total exports in 1976, as compared to 7 percent of total imports and 36 percent of total exports in 2003. These trends show that the industrial sector is more import-dependent, and therefore sources most of its intermediate inputs from outside the economy.

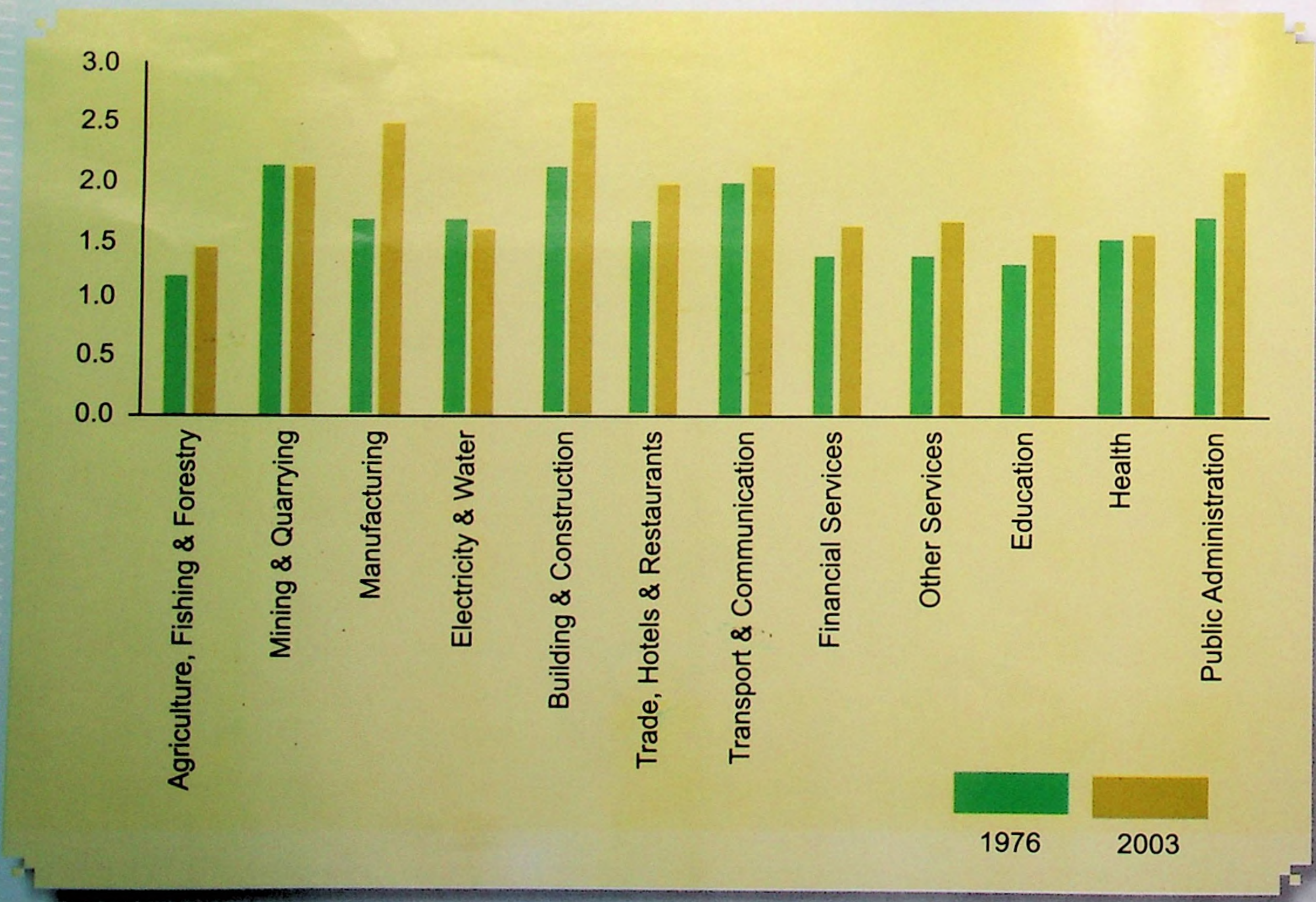
Sectoral Linkages within the Economy

One of the ways of stimulating growth in the economy is by strengthening inter-dependencies between sectors. This implies stimulating demand for both intermediate inputs (where sectors source their inputs— backward linkages) and also for final products (which is demanded as inputs into other sectors —forward linkages). As shown above, final and intermediate demand are the major sources of growth for the economy, which implies that stimulating growth in these sectors is important for growth. Identifying the key sectoral linkages emphasizes the role that each sector plays in the development of the domestic economy. Identification of these key linkage sectors informs domestic policy directed towards economic development in the economy. The analysis of absolute backward and forward linkages will also indicate how the outputs of the key sectors are distributed backward and forward to others in the domestic economy. Therefore, development policies focused on the key sectors will have an impact on the remaining sectors, which can be observed by the policy maker. Thus, priority sectors for growth should have the highest backward and forward linkages.

On average, most sectors recorded an increase in the level of backward linkages between 1976 and 2003 (Figure 1). Manufacturing, and building and construction recorded the highest increments, with manufacturing increasing from 1.7 in 1976 to 2.5 in 2003 and building and construction from 2.1 to 2.7. Overall, this shows that these sectors were more inter-linked in 2003 as compared to 1976, which implies that they source inputs from each other more than before, and are therefore more inter-dependent.

Forward linkages (Figure 2) were relatively constant between the two periods, except for agriculture and manufacturing. The coefficient for agriculture increased from 1.7 in 1976 to 2.0 in 2003, while manufacturing recorded the highest increment from 4.8 to 7.6. Private service sectors recorded marginal increments: trade, hotels & restaurants from 1.7 to 1.8; transport & communication from 1.9 to 2.0; and financial services from 1.6 to 1.8.

Figure 1: Backward linkages (1976 and 2003)



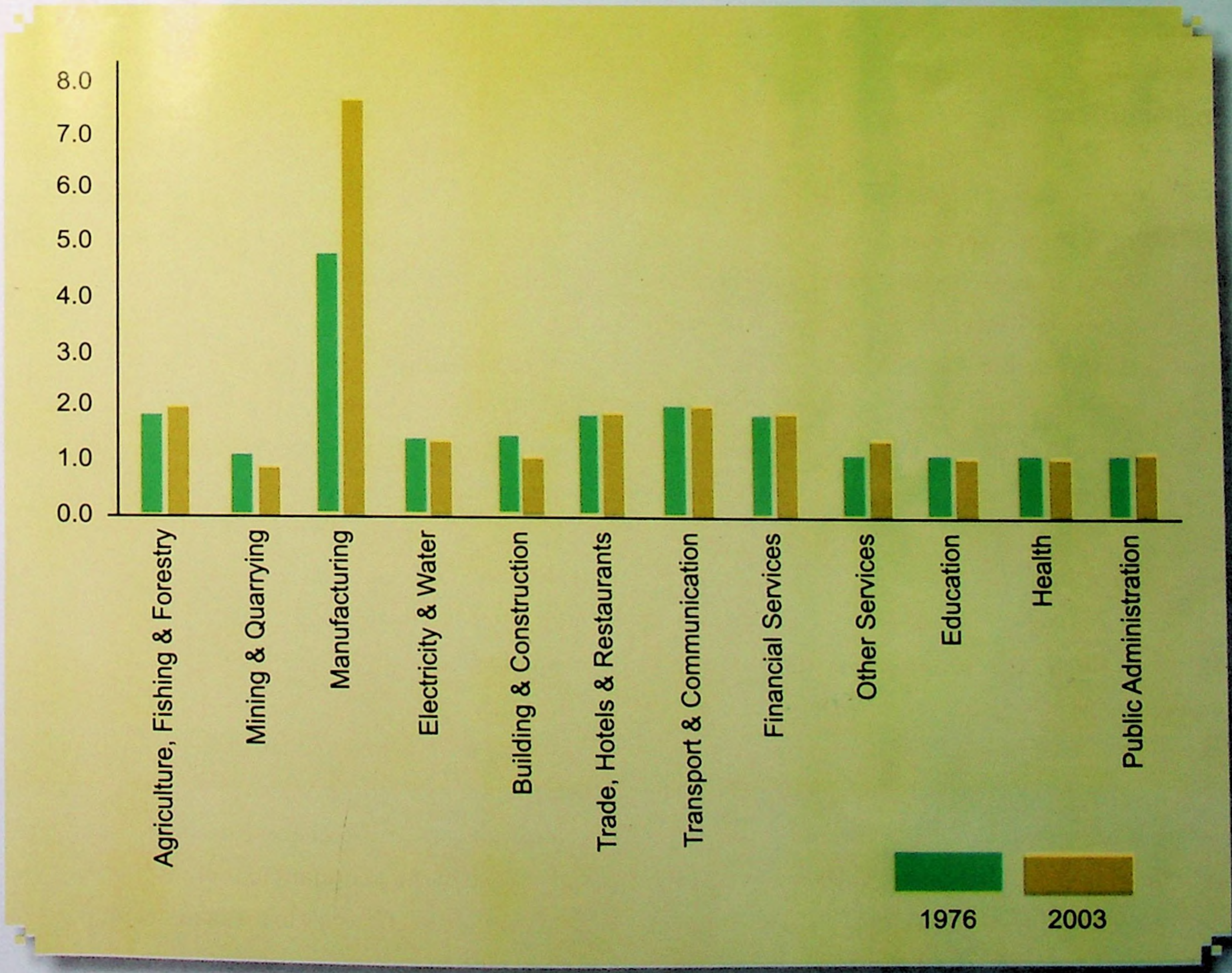
> The current growth performance shows that private services are the drivers of growth. However, given that the forward and backward linkages for private services are relatively lower than agriculture and manufacturing, then their capacity to generate synergies in other sectors is lower. Thus, there is need to enhance this level of inter-sectoral linkages since they are important for growth.

This analysis shows that most output from agriculture and manufacturing is used as inputs into other sectors, which explains why manufacturing and agriculture have continued to be priority sectors for growth as earlier outlined. The current growth performance shows that private services are the drivers of growth. However, given that the forward and backward linkages for private services are relatively lower than agriculture and manufacturing, then their capacity to generate synergies in other sectors is lower. Thus, there is need to enhance this level of inter-sectoral linkages since they are important for growth.

Conclusion

Kenya's economic growth experience has resulted into several outcomes. First, it has been shown that the economic growth policy strategies pursued by the government have placed great emphasis on agriculture and manufacturing as the key sectors that would lead to the growth and development of the economy. However, these sectors (especially manufacturing) are yet to play their optimal role in Kenya's development process. The value added from manufacturing has been fairly stable while agricultural value added has declined over time, as compared to increasing value

Figure 2: Forward linkages (1976 and 2003)



added from private services. The analysis of backward and forward linkages shows that these sectors are important priorities for growth given their strong linkages. Thus, there is need to pursue policies that would revitalize these sectors so that they can play their role in development.

Secondly, the economy has become more capital-intensive and is therefore not making use of the abundant labour resources. In addition, the efficiency of capital has declined. This shows that a more efficient use of factors of production could lead to higher output growth. Also, the declining share of labour in total value added implies that employment synergies of growth are lower. For the economy to meet the objective of growth and employment creation as set out in the Economic Recovery Strategy for Wealth and Employment Creation (2003), there is need to re-examine the relative mix of the factors of production so as to make use of the comparative advantage of abundant resources.

Thirdly, the analysis of backward and forward linkages has shown that inter-sectoral stimulation of demand has increased. However, increased import dependency has undermined the creation of synergies within these sectors. For instance, manufacturing has the highest linkages but it is highly import-dependent. There is need to strengthen the sector's linkages by encouraging production for export.

Lastly, Kenya has not followed the hypothesized development path of moving from agriculture to industry and finally to a knowledge-based economy as has been the experience in most developed countries, especially the Asian Tigers. Although the country has a strong agricultural base, private services have been driving the economy since 2000. The main limitation of such a development path is that the services industry is considered volatile and therefore unsustainable. The services sector requires to be supported by a vibrant agriculture and manufacturing industry. A look at the economic growth trends reveals that overall growth pattern follows the performance of the agriculture sector. A faster growing agriculture sector and a more vibrant manufacturing sector, especially in sectors with direct synergies (such as food processing) implies higher overall growth.

Policy Recommendations

Economic growth experience indicates that the Kenyan economy has undergone structural transformation in terms of sectoral contribution to value added and also the relative importance of factors of production. It is clear that the current pattern of growth, which is a services-led growth, is not sustainable given the economy's level of development and also by looking at the country's comparative advantage. A more sustainable growth pattern will entail prioritizing sectors with the highest linkages and hence growth potential within the economy. These sectors are agriculture, manufacturing and private services. This has been the focus of policy, but the outcomes have been varied. The following recommendations should be considered in stimulating and sustaining economic growth for the economy.

Increased value addition

To maximize the economy's economic growth potential, there is need for increased value addition in agriculture and manufacturing, which have a huge potential for growth. Value added in these sectors has been declining over time, which explains why they have not played their role in stimulating and sustaining growth.

Efficient allocation of resources

Growth potential would be maximized through a more efficient allocation of available resources. In addition to making use of the abundant labour resources, there is need to increase efficiency in the use of capital. Policies aimed at increasing efficiency include improvement in both the level of technology and also the productivity of factors of production (labour and capital). This will ensure that the economy experiences growth with employment synergies, which is one of the country's objectives as envisaged in the Economic Recovery Strategy.

Re-evaluation of export policies

It was shown that growth in output between 1976 and 2003 was mainly demand-driven (both final and intermediate demand). Investment and exports did not play a major role in contributing to growth in output. This has implications on pursuing an export-led development strategy. Increased openness has widened the trade balance and sectors have become more import-dependent. Policies aimed at increasing exports should be re-evaluated to ensure that exports play a bigger role in contributing to economic growth. These include policies aimed at diversifying and increasing the export base, as well as enhancing competitiveness of the economy's products. This can be achieved through quality improvement, value added processing, improved packaging and presentation, new product design and styling, identification of new exportable products, and adherence to industry code of practice.

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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