MINISTRY OF FINANCE

PUBLIC SECTOR WAGE POLICY STUDY

A Review of Recent Developments on Wage Structure and Policies with Particular reference to the Public Sector in Kenya

H. Mule

T.C.I. Ryan

D. Ndii

July 2004

PUBLIC SECTOR WAGE POLICY STUDY

A Review of Recent Developments on Wage Structure and Policies with Particular Reference to the Public Sector in Kenya

H. Mule
T.C.I. Ryan
D. Ndii

July 2004

TABLE OF CONTENTS

Chapter One: OVERVIEW 7
1.1 Background and Context 7
1.2 Synopsis of the Report 9
1.3 Conclusions 16

Chapter Two: MACROECONOMIC POLICIES AND THE WAGE RATE: AN OVERVIEW 19
2.1 Background and Context 19
2.2 Deregulation 21
2.3 Wage Deregulation 23

Chapter Three: THE WAGE RATE AND ECONOMIC PERFORMANCE 25
3.1 Growth 25
3.2 Provision of Public Goods 29
3.3 Employment and Incomes 32

Chapter Four: PUBLIC SECTOR PAY 40
4.1 Pay Determination: Institutions and Policies 40
4.2 Wage Trends in the Public Sector 46
4.3 Fiscal Consequences of Wage inflation 48
4.4 Structure of Pay in the Public Service. 50
4.5 Adequacy and Competitiveness of Pay in the Public Sector 52
4.6 Pay and Performance 54
4.7 Affordability: Fiscal Dimensions of Public Sector Pay Reform 55

Chapter Five: POLICY IMPLICATIONS, OPTIONS AND PROPOSALS 58
5.1 Policy Implications 58
5.2 Policy Options and Proposals 59
5.3 Financing Public Pay Reform 64

Chapter Six: CONCLUSIONS 66

APPENDICES AND ANNEXES
Appendix 1: Estimating the Impact of Public Sector Wages on Growth 69
Appendix 2: Econometric Analysis of Wage Determination in the Public and Private Sector 73
Annex 1: Institutions and Persons Consulted 76
Annex 2: Terms of Reference 78

ACKNOWLEDGEMENTS

This study has been conducted for the Ministry of Finance by a team comprising Harris Mule, T.C.I Ryan and David Ndii. Background papers for the study were prepared by Damiano Kulundu Manda, Dickson Khainga and the staff of Kenya Institute for Public Policy Research and Analysis (KIPPRA), Barrack Oduor-Otieno and Jackson M. Njage-Rwito. The team was chaired by Harris Mule. David Ndii coordinated the study and is the principal author of this report.

The study benefited immensely from consultations within and outside of Government. The team would like to thank in particular the following people for availing their time and expertise to the team: Hon. David Mwiraria, Minister for Finance; Hon. Prof. Peter Anyang' Nyong'o, Minister for Planning and National Development; Hon. Chirau Ali Makwere, Minister for Foreign Affairs (erstwhile Minister for Labour); Amb. Francis Muthaura, Secretary to the Cabinet; Andrew Mullei, Governor, Central Bank of Kenya; Simon Njau, PS, Directorate of Personnel Management; Zachary Ogongo, PS, Local Government; Joseph Magari and Deborah Ongewe, erstwhile PS Finance and Labour respectively; A.M.H. Sharawe, Chairman, and S.S. Boit, Secretary, Public Service Commission; Gaylord Avedi, Chairman, and Mark Bor, Secretary, Permanent Public Service Remuneration Review Board; David Namu, Chaiman, R.O. Wa-Mwenje, Secretary, and J.M. Otenyo, Member, State Corporations Advisory Committee; James Ongwae, PS Agriculture (erstwhile Secretary, Teachers Service Commission); Walter Mukuria, Chairman, and Tom Owuor (erstwhile Executive Director), Federation of Kenya Employers; George Ondiko Assistant Secretary General, Central Organisation of Trade Unions, COTU; and George Wesonga, 1st National Vice-Chairman, and David Okuta, Assistant Secretary General, Kenya National Union of Teachers, KNUT. A complete list of the people consulted, all who we thank very sincerely, is provided in the appendices.

Funding for the study was provided to the Ministry of Finance by the United States Agency for International Development (USAID). The team thanks Kiert Toh, USAID Mission Director, for his invaluable support and encouragement; Njeru Kirira, Financial Secretary, Ministry of Finance; and Prof. Mwangi Kimenyi, Executive Director, and staff of KIPPRA for excellent facilitation.

H. Mule
T.C.I. Ryan
D. Ndii

LIST OF ABBREVIATIONS

CBAs	-	collective bargaining agreements
CBS	-	Central Bureau of Statistics
CG	-	Consultative Group
COMESA	-	Common Market for Eastern and Southern Africa
CPI	-	Consumer Price Index
CRSP	-	Civil Service Reform Programme
EPZs	-	export processing zones
FDI	-	Foreign Direct Investments
IMF	-	International Monetary Fund
KNUT	-	Kenya National Union of Teachers
LFS	-	Labour Force Survey
OLS	-	ordinary least squares
O&M	-	Operations and Maintenance
PPP$	-	purchasing power parity dollar
REER	-	real effective exchange rate
SCAC	-	State Corporations Advisory Committee
SOEs	-	state-owned enterprises
T-bill	-	Treasury bill
TSC	-	Teachers Service Commission

Chapter One

OVERVIEW

1.1 BACKGROUND AND CONTEXT

Pay grievances and industrial unrest in the public sector

Immediately after assuming office in January 2003, the NARC Government was confronted with pay grievances and industrial unrest in both the public and private sectors. Strikes have occurred in the EPZs, public universities, public healthcare workers, and local authorities including the Nairobi and Mombasa City Councils. Settlements have been arrived at with the police force, the military, academic staff in public universities, and teachers. The grievances of the core Civil Service remain.

Public sector reform

Kenya experienced phenomenal growth of public sector employment from independence to the early 1990s. Civil Service employment, excluding teachers, increased from 88,600 at independence to over 273,700 by 1990, representing an annual growth rate of 4.4 per cent, significantly faster than population growth during the period (population growth rate was 3.57 per cent per year). Public employment in the other sectors (teachers, local government and parastatals) grew even more dramatically, from 76,000 to 427,000 over the same period, representing an annual growth rate of 6.4 per cent. In total, the public sector increased from 30 per cent of formal wage employment in the economy at independence to stand at 50 per cent in 1990. The pressure on the budget by this expansion made it impossible to compensate public servants adequately and to provide sufficient complementary resources required for effective service delivery. The average wage bill increased from under 50 per cent of ministries' recurrent budget pre-1980 to over 70 per cent in the mid-1990s, with some, education notably, exceeding 90 per cent.

A concerted effort to contain the public wage bill has been underway since the early 1990s, under the Civil Service Reform Programme (CSRP). Through a combination of retrenchment and attrition (non-replacement of retirees), Central Government employment has been reduced to 194,000 as at end of 2003, achieving a staff to population ratio of 1:165, well below the 1:106 ratio at independence or the 1:86 in the year 1990. This reduction, however, has not delivered the desired increase in operations and maintainance outlays or a sustainable public wage bill. That said, staff reduction has proceeded in the

absence of an overall wage policy. As a result, distortions within and between services (e.g. between teachers, health workers, and police) have increased. These distortions are largely responsible for the explosion of wage demands since the NARC Government came into power.

More significantly, this cost containment effort has been focussed almost exclusively on the Central Government. This anomaly is most amply demonstrated by dramatic and disturbing developments in the Local Government service. Notwithstanding that a reform programme (the Local Government Reform Programme) has been in place, the annual Local Government wage bill has rocketed from Kshs 1.8 billion in 1992 (equivalent to only 7 per cent of Central Government wage bill) to Kshs 21.4 billion in 2002 (equivalent to 77 per cent of the Central Government wage bill) on account of both increase in numbers employed and the average wage. Overall, the savings generated by reduction of Central Government employees (by 79,000 from the peak in 1991 to 2002) has been more than offset by higher wage outlays elsewhere, in Local Government as demonstrated above, as well as teachers and state corporations that are directly funded from the Central Government budget and financing of the obligations, such as debt service, that have been crowded out by their increased wage outlays.

Economic recovery strategy

The NARC Government has committed itself to an economic recovery strategy predicated on empoyment creation. The reasons for this are twofold: First, youth unemployment is arguably the most daunting economic challenge facing Kenya today. Over a million mostly young people are estimated to be unemployed. The unemployement rate, as recorded in the 1999 census, was highest in the 15-19 age group at 19.4 per cent, falling to 16 per cent in the 20-24 cohort, to 9.4 per cent in the 25-29 cohort and below 6 per cent among those over 30. Second, employment, broadly defined to mean full utilisation of the productive potential of the labour force, is the pivotal link between economic growth and poverty reduction. Kenya is poor in natural resources and arable land; it is therefore the people that are the means to national prosperity. *To generate employment, Kenya has no choice but to become a competitive producer of labour intensive goods and services for both the domestic and external markets.*

Purpose, objectives and scope of the study

The purpose of the study is to establish the causes of wage distortions and unsustainable growth of the public wage bill, with a view to identifying policy and institutional reforms that will ensure that pay is *adequate, equitable, affordable* and *supportive of economic recovery*. The Terms of Reference are provided in Annex 2.

The study is intended to provide a policy framework for determination of public sector pay. In this regard, the study's principal objective is to propose principles and rational criteria that can be applied uniformly in all pay determination processes. The study covers the public sector as a whole, namely, the Central Government, local authorities, teachers and parastatals. Included in parastatals are state corporations (i.e. agencies and enterprises wholly owned by the State), and state-controlled enterprises (i.e. enterprises in which Government has a majority stake).

The study is organised into six chapters as follows. This Chapter provides an overview in three parts, namely this background, a synopsis of the study and the conclusions. Chapter Two provides a broad economic policy background by way of a review of wage developments in a macroeconomic policy context. Analysis of the economic impact of wage rate is presented in Chapter Three. Chapter Four addresses itself to public sector pay determination. It reviews wage trends, structure and determination processes, and evaluates the pay structure and levels vis-à-vis the market and international public service pay norms. Chapter Five presents the study's policy implications, options and proposals. Chapter Six concludes.

1.2 SYNOPSIS OF THE REPORT

Introduction

Over the last decade, Kenya has experienced an unprecedented escalation of wages in both the private and public sector. Average pay in the private and public sectors increased from Kshs 4,720 per month and Kshs 4,600 in 1994 to Kshs 22,230 and Kshs 22,400 respectively, representing an annual growth rate of 17 per cent. Notably, public sector wage has grown marginally faster than the private sector wage. In real (i.e. inflation-adjusted) terms, average wage has grown by 7 per cent per year. Over the same period, GDP per capita contracted, a trend that available data indicate is in part due to declining productivity. In effect, the real wage rate has been rising, while productivity has been falling. If the real wage rises faster than productivity, it erodes the competitiveness of Kenyan goods and services in both domestic and foreign markets, and encourages more capital intensive production to the detriment of employment. This trend therefore portends very adverse consequences for growth, employment creation and poverty reduction.

In the public sector, wage escalation has manifested itself in two critical challenges: First, the public wage bill is growing much faster than revenues. This is not sustainable. The consolidated public wage bill grew from Kshs 66 billion in 1997 to stand at Kshs 161.3 billion in 2003, representing an increase of 144 per cent. Over the same period, the direct wage obligation of the Central Government, which comprises the salaries of civil servants and teachers, grew

from Kshs 39 billion to Kshs 75.6 billion, representing a 93 per cent increase, as compared to a revenue increase of 63 per cent. The Local Government wage bill increased by 210 per cent from Kshs 7.9 billion to Kshs 24.6 billion, against revenue increase of 97 per cent. The wage outlay of state corporations and enterprises increased by 220 per cent from Kshs 19 billion to Kshs 61 billion. Although revenues are not available for comparison, it is doubtful that they are keeping pace.

Second, the increases in pay have been highly inequitable. There are three dimensions to the inequities:

(1) Disparities between the public services

As at end of 2003, the average wage in the Civil Service stood at Kshs 12,280 per month, as compared to Kshs 16,000 in the teaching service, Kshs 23,980 in Local Government service, Kshs 32,130 in state corporations, and Kshs 42,290 in state-controlled enterprises (majority owned by the Government). In percentage terms, the average Civil Service pay is 70 per cent of teachers pay, 50 per cent of local government pay, 40 per cent of state corporations pay and only 30 per cent the average pay in state-controlled enterprises. A decade ago, the pay structure was radically different. In 1992, average pay in the Civil Service was 35 per cent higher than in the teaching service, 31 per cent higher than in local government service, and only 6 per cent and 10 per cent below average pay in state corporations and state-controlled enterprises, respectively.

(2) Inflated executive compensation

This problem relates to compensation of the upper echelons in the public sector, ranging from Permanent Secretaries, Judges, the executive cadre in parastatals, members of various commissions, and Members of Parliament. Kenya's public sector executives are overcompensated relative to other cadres and by international standards. In 2003, the top salary in the public service (excluding parastatals) was Kshs 700,000 per month. The average monthly pay of Permanent Secretaries and equivalent cadres was Kshs 450,000. In the parastatal sector, the highest paid executive earned Kshs 1.3 million per month. The average pay for chief executives of commercial corporations was Kshs 460,000 while CEOs of non-commercial corporations earned on average Kshs 318,000 per month. A salary of Kshs 700,000 per month translates, in purchasing power terms, to a US salary in the region of US$ 290,000 per year, while Kshs 1.3 million per month translates to US$ 550,000 per year. By way of comparison, executive pay in the international public service will be in the range of US$ 120,000 - 180,000 (US$ 90,000-130,000 net) per year. For instance, the net salary of an Undersecretary General in the United Nations, the highest office after the Secretary General, is currently US$ 125,000, while that of an Assistant Secretary General is US$ 115,000.

(3) *Undercompensation of the middle cadres in the Civil Service*

Within the core service, the inflated executive compensation, and suppression of pay in the middle cadres has translated into a highly distorted compensation structure. This is characterised by competitive pay at the low end, over compensation at the top and severe undercompensation in the middle. Currently, the highest salary is 118 times the lowest paid, and 53 times the median salary. By way of comparison, the highest salary in the Botswana public service, arguably the most effective public service in the region, is only 30 times the lowest, and 4 times the median. In purchasing power terms, the highest salary in the Botswana public service translates to an equivalent of just over Kshs 200,000 per month. At Kshs 6,000, the lowest salary in the Kenya public service compares favourably with Botswana (Kshs 6,800). However, at Kshs 13,300, the median salary in Kenya compares very unfavourably with Botswana where the median salary is equivalent to Kshs 45,000. The distorted pay structure is not only out of line with regional best practice, but also in relation to Kenya's historical public pay norms, established on the recommendations of the Ndegwa Commission of 1971. In current (2003) prices, this established a structure starting at Kshs 7,900, rising to Kshs 53,000 in the middle, and to Kshs 300,000 at the top.

Key findings of the study

Wage formation in the economy

The problem of wage inflation in the economy has its genesis in the deregulation of the labour market in the early 1990s. Before then, wage control was administered by means of Wage Guidelines issued by the Minister of Finance to the Industrial Court from time to time. The Guidelines stipulated a ceiling on wage awards to a fraction of the increase in the cost of living, and a two-year interval between negotiations. Implicit in this was a policy of reducing the real average wage and wage inequality over time. The last Guidelines issued in 1994 removed both ceilings. The Guidelines envisaged that productivity would replace cost of living as the primary criteria for wage adjustment. For the purpose of measuring, as well as enhancing productivity, a National Productivity Centre was to be established. The Centre has been extremely slow in taking off, and although it is now operational, it is yet to embark on the analysis and education necessary for this transition.

The effect of deregulation has been a free bargaining regime, evidently not linked to, or informed by either cost of living compensation or productivity growth. At best, productivity in the economy has been stagnant over the last decade. An estimate for manufacturing sector reported in the Economic Survey shows labour productivity as having contracted by 1.6 per cent over the last five years (1998-2003), while the average wage in the manufacturing sector has been increasing by 8 per cent per year in real terms. This trend portends

grave economic consequences for job creation, and poverty reduction in particular. Given the small size of the domestic market in relation to new jobs required, growth and employment hinge on competitiveness in general, and on attracting investment in production of labour intensive goods and services for the world market in particular.

Labour costs and productivity are the most important determinants of competitiveness, which means that Kenya cannot afford to become a high wage cost economy relative to competing locations. In dollar terms, the cost of labour in manufacturing has increased by 43 per cent from US$ 183 to US$ 253 per month in the last five years. As noted, labour productivity has been falling. It is hardly possible that Kenyan manufacturers can pass this cost to consumers in other markets, which means that Kenya is that much less attractive as a location for export manufacturing than it were five years ago. In the Trade Restaurants and Hotels sector, the average dollar wage has increased by 75 per cent, from US$ 248 to US$ 432 in the same period. This trend will adversely affect Kenya's tourism industry vis-à-vis competing destinations in the region and elsewhere, particularly since this is a relatively labour intensive sector.

The rise in wage rates has been associated with a declining national saving rate, and consequently investment. Over the last decade, the consumption share of national income has risen from 83 per cent to 90 per cent of GDP; in other words, the national saving rate has fallen from 17 per cent to 10 per cent of GDP. Additionally, this increase is accounted for wholly by public consumption (i.e. government expenditure per capita), which has increased by 8 per cent in real terms. This increase has occurred alongside marked deterioration of public services in particular education, healthcare and security. The impact of non-provision of public goods falls heavily on the poor, who either go without, or have to sacrifice other basic needs such as food and clothing. It stands to reason then, that the impact of the wage rise on income distribution is highly regressive. This was clearly demonstrated by the overwhelming response to the free primary education programme.

Wage determination in the public sector

The relaxation of Wage Guidelines opened public sector pay determination to various influences that have undermined rational wage determination. The first of these was the advent of exemptions of state enterprises slated for privatisation from certain provisions of State Corporations Act, including those prescribing the salary structure and review process. This opened the way for other state corporations, including non-commercial ones, to seek similar exemptions. Additionally, in 1990 the term of the State Corporations Advisory Committee, the body established by the Act to advise the Government on remuneration, expired without renewal or appointment of a new committee. Therefore, the state corporations sector remained without a formal wage

determination process up until the constitution of a new committee by the NARC Government.

The second influence emanates from industrial relations arrangements that render collective bargaining processes in the public sector susceptible to conflict of interest. This anomaly is most readily apparent in the case of unionisation of academic staff in public universities, as the university administrators are themselves academic staff, and in effect beneficiaries of collective bargaining agreements. A similar situation obtains in the Local Government service, where all employees, including town clerks, are unionisable. But even where management staff is not unionised, as is the case in state corporations, conflict of interest arises. Even though they are not unionised, the interests of management cadres in the public sector are aligned with those of unionised employees. This is because an increase in the pay of unionised workers necessary provides a justification for increasing management pay. Unlike the private sector, public sector managers can expect to pass on the costs to the taxpayer. It follows then, that public sector managers cannot represent the best interests of the public in wage negotiations.

The third influence on wage formation in the public sector is competitive politics. The confluence of political liberalisation of politics and deregulation of the labour market in the early 1990s ushered in an unprecedented industrial relations regime in Kenya. Before then, the combination of one party and the wage control regimes constrained exercise of political influence on wage determination. This is clearly demonstrated in the highly politicised nature of the long running pay dispute between the Government and teachers. The size of the award (over 200%) against the backdrop of severe budget constraints, and its timing (in the run-up to the 1997 general elections) suggest that the award was politically motivated, more so since neither the Government nor the Union when asked were able to offer a rational explanation.

The effect of these pay distortions has been to undermine performance in and the structure of the public service. The wage structure in the Civil Service that does not reward professionals and middle level managers adequately has adverse consequences on effort and morale. In addition, these cadres have been depleted by voluntary departures due to inadequate compensation and the attrition policy (non-replacement of retirees) pursued under the Civil Service Reform Programme, to the effect that there is now a serious problem of succession and loss of institutional memory in the senior cadres of the Civil Service.

The pay premium that employees of state corporations enjoy over the Civil Service has led to institutional inflation and fragmentation, indeed "balkanisation", of the public service. It has become the norm for every new policy initiative to give birth to a new state corporation, by way of "migration" of government departments, or by way of establishment of secretariats to serve various boards, councils and commissions that would hitherto have been

served by civil servants. The first route includes Kenya Revenue Authority, Kenya Wildlife Service, Kenyatta National Hospital and the Kenya Medical Supplies Agency. The latter include the Kenya Roads Board, the NGO Coordination Bureau, the National Aids Control Council and the Commission for Higher Education.

Policy implications and recommendations

The study identifies three objectives that public pay policy should address. These are:

(1) Arresting wage inflation in the economy, and ensuring that wages are aligned to productivity,

(2) Ensuring an affordable and sustainable public wage bill, and

(3) Achieving adequate and equitable compensation in the public service.

These objectives need to be pursued jointly. Neglecting any one of them, or trading off one against the other, will undermine the overall efficacy of public expenditure and socio-economic policy goals. To this end, the study proposes a three-pronged strategy as follows:

(a) Adoption of a wage growth target

A macroeconomic policy target for wage growth should be established as soon as possible. The policy ambivalence towards the wage rate that has obtained over the last decade represents a critical delinquency in macroeconomic policy. The relaxation of Wage Guidelines was predicated on the adoption of productivity-driven wage formation in the economy. But as pointed out, real wages have continued to outstrip productivity by a large margin. Arguably then, there is no economic justification for further increases in the real average wage in the immediate future. The study recommends that a wage policy to fill the void left by the Wage Guidelines be pronounced and implemented as a matter of urgency. It is our opinion that in the first instance, this should be implemented by way of revising the 1994 Guidelines, which, although abandoned in practice, are still legally in force.

(b) Consolidated public sector approach to wage bill management

As noted, the effort to control the wage bill has in the past focussed primarily on the core Civil Service, to the exclusion of the teaching service, Local Government and state corporations. One of the principal objectives of reduction of the size of the Civil Service was to increase the resources available for operations and maintenance (O&M). This has not been achieved. Rather, the resources generated have been absorbed by wage outlays elsewhere in the public sector. In other words, the objective has been undermined by the "revolving door" syndrome. It is in this regard that the study recommends that the Government needs to broaden the purview of its wage bill

management specifically, and fiscal strategy generally, to encompass the consolidated public sector. To this end, it is imperative that the Treasury finds ways and means of imposing "hard budget constraints" on all organisations whose wage outlays are directly or indirectly a charge on the public purse, either in current obligations or contingent liabilities. The former applies to teachers' salaries and wage outlays of non-commercial parastatals, and the latter to financial obligations of local authorities and debt servicing obligations of self-financing state corporations.

(c) Rationalisation of pay in the public service

As stated earlier, the overarching objective of this study is to propose the principles that should inform the determination of pay in the public service. Determination of public sector wages requires cognisance of factors other than the going market wage rate. Indeed, for many services provided by Government, such as national defence, there is no going market rate. Consequently, the relationship between public and private sector wages varies widely between countries, reflecting their different traditions, values, economic objectives and political realities. The study makes rationalisation proposals premised on, and informed by two principles.

The first principle relates to public service ethics and values. There is indeed a conflict between the ethos of public service, and the ethos of enterprise. The ethos of service, in careers like teaching, medicine, the military and priesthood, requires people who are motivated by a sense of duty — a "calling" so to speak — while the ethos of enterprise requires people who derive satisfaction from reward for risk. Simply put, this is to say that money should not be the primary motivation and reward for a career in the public service.

It may appear to public sector employees that because they earn less than peers in the private sector, they are undercompensated relative to the market wage; this would only be the case if they have qualifications that are in demand in the private sector. It is, for instance, argued in some quarters that executive compensation in the public service should be pegged to the market — that is, to executive pay in the private sector. This argument is flawed. From an economic standpoint, it would only be valid if the public sector managers have the qualifications and experience to compete for the highly paid executive jobs in the private sector, in which case private sector executive pay would be the relevant opportunity cost. Analysis presented in the study shows that this is not the case. It shows that, on average, the qualifications of the typical public sector employee would command less in the private sector than what they earn in the public sector.

The second principle is fairness. This dictates equal pay for equal work. The essence of this principle is that compensation for similar function ought to be the same across the public service, irrespective of whether the job is in Civil Service, state corporations or local authority. Conversely, organisations that

are fundamentally different in values and functions should not be subjected to the same pay norms simply because they are in the public sector. For instance, state corporations range from core governance functions, such as law enforcement (Kenya Anti-Corruption Commission), to commercial enterprises competing in the marketplace, such as Telkom Kenya.

The study therefore proposes that functional rationalisation of the public sector be undertaken as a prelude to pay review. A three-tier functional structure is proposed as follows:

(a) *Core governance and service delivery functions*. These should be brought under unified terms and conditions of service based on the Civil Service job classification. This will attenuate institutional inflation (i.e. proliferation of parastatals whose primary motivation would appear to be pay and patronage). In other words, public servants should be indifferent between the public services in terms of compensation, career prospects and stature.

(b) *Secondary service delivery functions*. These include public goods such as higher education and research and development authorities (defined in this study as secondary government). The study recommends that the Government should delink itself from the pay determination in these organisations by moving towards block grant and "fee for service" funding.

(c) *Commercial (i.e. for profit) functions*. In this category, the study includes all publicly-owned or controlled enterprises and state corporations that endeavour to generate a surplus from their operations. The study recommends that the boards of directors should be allowed to adopt private sector pay practices, but within parameters established by productivity-based performance contracts with the government.

1.3 CONCLUSIONS

Kenya is rapidly becoming a high wage cost economy. This is an urgent policy challenge as it threatens external competitiveness, macroeconomic stability and fiscal sustainability, which are the necessary conditions for poverty reduction, job creation and growth. The study highlights two significant positive responses of the economy to deregulation, namely, export growth as well as diversification, and job creation, including reviving job creation in the agricultural sector. This trend reversed in the latter half of the 1990s. The evidence points to escalation of wages as the probable cause. The study draws two inferences from this analysis. First, external competitiveness is the critical link between growth and employment. Put differently, the sources of growth matters. Job creation by domestic absorption, by means of direct public employment, fiscal stimulus, or protection and/or subsidies is both inequitable and unsustainable. Second, to the extent that labour absorption in agriculture is pro-poor, this analysis provides strong evidence that macroeconomic competitiveness is critical for both job creation and poverty reduction.

The study avers that the wage problem in all its dimensions is a consequence of the failure to institutionalise liberalisation. This is its principle message. Building institutions to govern liberalised markets must become one of the government's foremost good governance agenda. In the economics discourse, it is now universally acknowledged that factor markets (labour and capital), suffer from more severe information asymmetry than product markets, that is employers and lenders lack adequate information about the attributes of workers and borrowers, respectively. This gives rise to pervasive market failure, that is, prices (wages and interest) do not adjust as they should to equate the demand and supply, the result of which is persistence of voluntary unemployment and credit rationing.

Viewed from this perspective, the observed impact of deregulation on the labour market – rising wages alongside high unemployment – and inordinately large spreads between deposit and lending rates in the aftermath of deregulation of interest rates, are both consequences of the failure to adapt policies and build institutions for governing markets. A deregulated banking sector requires a statutory consumer protection function, assigned to either the monetary authority, financial sector regulator or competition authority. Had this been envisaged and implemented when interest rates were deregulated, the "Donde Bill" saga would not have occurred. In the case of wage deregulation, some institutional reform was envisaged but not implemented. Quite evidently, wages have been outstripping productivity for well over a decade; it does not seem to have become a concern to the relevant authorities, suggesting perhaps that policy makers have not appreciated the adverse socio-economic consequences of a high wage cost economy highlighted in this study.

With regard to public sector, the labour market problem is compounded by pervasive conflict of interest in the wage determination institutions and processes. There are three dimensions to this problem. The first is that of public officers being judges in their own case, the most glaring one being that of Members of Parliament. The second is the wide latitude of discretion that senior cadre of the Civil Service has to adopt and implement selectively recommendations made by pay review commissions. The third, which applies mostly to state corporations, is that the interests of the managers who negotiate collective bargaining agreements (CBAs) are aligned with those of their co-workers as opposed to the public interest since increases in the compensation of unionised workers necessarily justifies upward adjustment of their own. This institutional failure underlies the glaring distortions in the public sector pay structure, in particular, the wide gap that has opened between state corporations and the rest of the public sector, and the inflated salaries of senior cadres relative to domestic market and international public service pay norms. The latter (i.e. the executive wage premium) is in part responsible for the institutional inflation that has been characteristic of the public sector since

independence, on account of the vested interest of the national elite to create more jobs for themselves. This is in our view perhaps the most fundamental public sector reform issue that the Government needs to confront.

The issues raised in the study constitute a formidable but inescapable agenda for policy and institutional reform and capacity building. The study amply demonstrates that over the last decade, macroeconomic policy in Kenya has not paid sufficient attention to the labour market. This oversight needs to be addressed as a matter of urgency. In addition to the adverse growth and employment consequences that have been highlighted, failure to do so portends risk of a wage inflation spiral; that is, rising wages fuelling inflation, precipitating further wage demands, which fuel more inflation. This genre of inflation is much more difficult to manage than the traditional sources of inflation in Kenya, namely fiscal deficits and exchange rate depreciation.

Although the study makes some specific proposals, the purpose is to propose an evidence-based policy framework (i.e. principles and criteria that are consistent with socio-economic goals and fiscal sustainability). There are several areas of further study that are suggested by. A better understanding of the labour market is required. Equally important are studies on productivity, in the public sector in particular, and on economic and social returns of public expenditures.

Finally, addressing the issues raised in the study is not the responsibility of the government alone; collective action, enjoining employers, the labour movement and development partners is required. Trade union leaders, in particular, need to be persuaded that wage settlements that have adverse consequences on the economy are not in the best interests of workers. Development partners also need to be more cognisant of the unintended adverse consequences of their preferences. They have contributed to the pay and expenditure distortions in various ways, notably by financing inflated executive salaries, and by dint of their historical bias for capital over operations and maintenance outlays. Above all, the government must lead by example. As long as the culture of privilege that has taken root in the senior cadres of the public service obtains, the government will lack the moral authority to demand sacrifice of others.

Chapter Two

MACROECONOMIC POLICIES AND THE WAGE RATE: AN OVERVIEW

2.1 BACKGROUND AND CONTEXT

The wage rate is one of four fundamental price variables that determine the allocation of resources and distribution of income in the economy. The others are the rate of interest, the exchange rate, and the general price level.[1] The primary objective of macroeconomic policy is to maintain stability and predictability of these prices, and to ensure that their levels and rates of change are consistent with the ultimate socio-economic goals, these being *employment*, *equity*, and *growth*. The intermediate objectives that ensure sustainability are a low and stable rate of inflation, a sound and efficient banking system, sustainable public finances, and a healthy balance of payments.

Figure 2.1: Macroeconomic price movements (inflation, interest, exchange and wage rates), 1964-2004

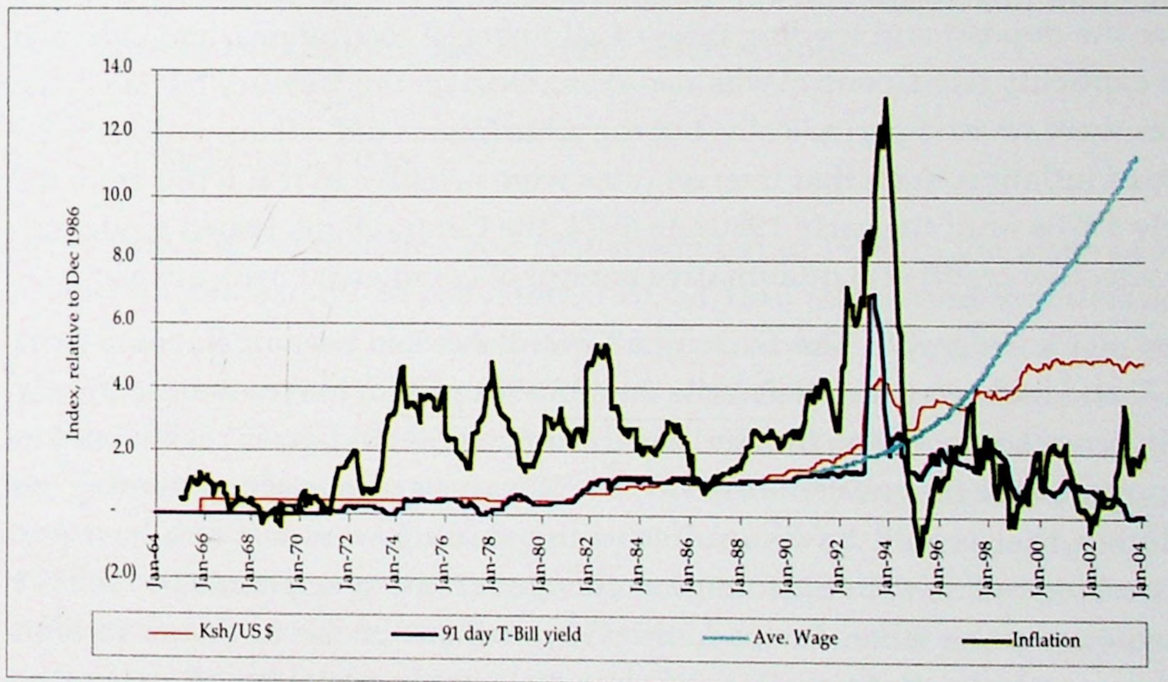


Figure 2.1 shows the evolution of the key macroeconomic variables since independence. The series in the graph are the average nominal wage earnings, the rate of inflation (change in CPI), the interest rates represented by the 91-day Treasury bill yield, and the US dollar exchange rate. For comparability,

[1] Strictly, the rental rate of land should also feature but a free market in land has not appeared yet in Kenya.

the series are normalised with 1986 as the base. As is evident, up until the early 1990s, the macroeconomic prices, with the exception of the inflation rate, were quite stable, and characterised by close co-movement. This is a reflection of the era of economic controls. Some controls date back to the colonial regime, but most were introduced or augmented at various times after independence as policy instruments, or in response to circumstances.

- *Price controls.* Price controls were first introduced during World War II as a means of protecting the poor from the shortages occasioned by the war, and expanded after independence. By the early 1970s, over 1000 goods were under Specific Price Control Order. In addition, there was a General Price Control Order under which many categories of products required government approval before manufacturers could raise prices. Movement controls of produce, including import and export licensing, curtailed any quantitative response to price differentials. Because price revisions were based on costs (under a Determination of Costs Order), firms did not have incentive to increase efficiency.

- *Interest rates.* Interest rate controls were instituted in 1966, following the transfer of monetary authority from the East African Currency Board to the newly established Central Bank of Kenya. The controls were exercised over the deposit and lending rates of all financial institutions, and although not explicitly fixed, control was also exercised over the Treasury bill rate.[2] The rates were revised periodically, but the adjustments did not keep up with the rate of inflation, such that interest rates were negative in real terms from the early 1970s until the early 1980s. In 1974, the Central Bank issued guidelines on selective credit and quantitative control of commercial bank advances.

- *Exchange rate.* The Exchange Control Act had been operational since 1967[3] and had been used to handle the 1971-73 crises of international currency turbulence surrounding the sterling, the dollar and gold. It was again used in response to the first oil crisis in 1973/74. This was a means of pre-empting the inflation that would have resulted if the shilling were left to adjust (i.e. depreciate) in line with the foreign exchange scarcity precipitated by the 1973 petroleum price hike. Instead, the Government chose to ration foreign exchange administratively. Nonetheless, the exchange rate misalignment, as measured by the black market premium, suggests that the official exchange rate remained reasonably close to the market value. Selective import controls were introduced under Sessional Paper No.1 of 1974 with further quantitative controls under Sessional Paper No.4 of 1975.[4]

---

[2] These were introduced in 1969. There was a cap on the rate and the bills were not freely auctioned.

[3] It replaced the colonial Exchange Control Ordinance.

[4] *Sessional Paper No.1: The Current Economic Situation in Kenya* (Nairobi: Government Printer, March 1974); *Sessional Paper No.4: Economic Prospects and Policies* (Nairobi: Government Printer, February 1975).

- *Wages.* Control of wages was envisaged and legislated under section 5 of the Trade Disputes (Amendment) Act of 1971,[5] but the power was not invoked until August 1973, just before the oil price shock. The Act gave the Minister of Finance power to issue Wage Guidelines to the Industrial Court. The Guidelines required the Industrial Court to apply two economic parameters, productivity and cost of living, in determination of pay awards following disputes brought before it, and before registering wage settlements arrived at in collective bargaining agreements. The Guidelines were revised every year for the next four years (1974-77), and three times thereafter — in 1979, in 1987 and in 1994.[6] Work permits and trade licences, which came into force in 1967, affected the demand and supply of labour. Tripartite agreements controlling wage increases in return for increased employment were effected in 1964, 1970 and 1979.

In addition to these controls on macroeconomic prices, there were a variety of administrative controls on resource allocation. Imports and movement of capital were controlled by means of foreign exchange and import licences. Foreign investment activity was controlled through a variety of licences, investment controls, and restricted access to domestic financial market. Furthermore, as has been pointed out, domestic commerce was governed by movement controls on principal commodities, notably maize and milk, and guidelines on bank lending among other interventions.

2.2 DEREGULATION

Deregulation of the economy was first attempted in 1979[7] in the wake of the second oil shock, and in the context of an IMF supported stabilisation programme. It was not sustained and the programme collapsed, a fate that befell three subsequent IMF programmes with the same objectives entered into in 1981, 1982 and 1984. The publication of Sessional Paper No 1 of 1986 on "Economic Management for Renewed Growth" was the beginning of sustained deregulation of the economy. Informed by the importance of a smooth transition to a market economy, and the appreciation of the need to build institutions for markets, the strategy enunciated in that paper envisaged a gradual deregulation. This strategy was followed despite increasing difficulties to 1992/93. Price decontrol was pursued by way of deleting batches of products[8] from the General and Specific Price Control Orders. That process was completed and the Orders abolished in 1992. Similarly, the deregulation

[5] Minimum wage legislation had been in use since 1951.
[6] An amendment due out in August 1982 was not effected because of the coup attempt.
[7] Report and Recommendations of the Working Party (on Public Enterprises), 1982.
[8] Progressively, the more sensitive items were removed having demonstrated to those worried about political implications, that orderly, non-inflationary decontrol was possible.

of interest rates began with a process of frequent adjustments targeting positive real interest rates, while the exchange rate liberalisation proceeded from a fixed rate to a managed float.

This gradualist regime came to an abrupt end in 1993, precipitated by two related events that were unanticipated at the time of writing Sessional Paper No. 1 in 1986. The first was the fall-out between the Government and the donors that culminated in the "aid embargo" imposed at the Consultative Group (CG) Meeting of November 1991.[9] The second was the political liberalisation – that is, the return to multiparty politics, which the Government reverted to abruptly in anticipation of the aid embargo. The run up to the multiparty elections in 1992 saw a total collapse of financial discipline, and the massive monetary expansion associated with the phenomena now known as Goldenberg. In the aftermath, the Government found itself with a massive monetary overhang (excess liquidity) and desperate shortage of foreign exchange. The price for resumption of donor support was the "big bang" liberalisation in 1993.[10]

The impact of the "big bang" liberalisation, both political and accelerated economic reforms, is clearly manifest in Figure 2.1. Inflation surged to an unprecedented 60 per cent at its peak in January 1994, the shilling devalued by 89 per cent in nine months – from Kshs 35.9 in January 1993 to Kshs 69.1 to the US dollar in October 1993.[11] The effort to mop up the excess liquidity drove the T-bill interest rates to 85.33 per cent by July 1993 from 17.88 per cent in February.[12]

It was not until mid-1995 that stability was restored. That said, the macroeconomic regime is radically different from the experience of the control regime. The exchange rate continued to drift until 2000, but has since stabilised with respect to the US dollar. Inflation, though subdued, remains volatile. Notably, inflation has surged in the neighbourhood of general elections, first in the run-up to the 1997 elections peaking in March 1997, and again in 2002, peaking in April 2003. This phenomenon, referred to by economists as "political business cycles", is the *raison d'etre* for granting Central Bank independence in the conduct of monetary policy.[13] Arguably therefore, the collapse of fiscal

---

[9] It is probable that the decline in Kenya's geopolitical significance following the 1989 collapse of the Berlin Wall had not been fully appreciated, nevertheless, the Government stated in one of the documents distributed at the Consultative Group Meeting that it was not adverse to multiparty politics.

[10] Technically one could say that the Government lost "ownership" of its economic reform process both with respect to timing and phasing, particularly the failure to establish and test the necessary complementary institutions.

[11] During this time, the parallel rate devalued by 219 per cent from Kshs 33.5 /US$ in May 1992 to Kshs 107.0/US$ in August 1993.

[12] The high interest rate attracted hot money and flight capital from abroad, causing the Kshs to appreciate.

[13] The pre-election periods have been periods of excessive money creation.

and financial discipline in the wake of the return to multiparty politics can be attributed to the failure to put in place the "agencies of restraint" that insulate economic management from political manipulation in democratic polities. *This problem is one consequence of the failure to institutionalise liberalisation in its many dimensions: the effort to address it is the overarching message of this study.*[14]

2.3 WAGE DEREGULATION

The movement of the wage rate since the "big bang" deregulation is by far the most dramatic. As was evident from Figure 2.1, the average nominal wage escalated apace with the other macro prices until 1995. Thereafter the average wage has continued to rise, even as the other prices have more or less stabilised. The gap between wage growth and inflation has continued to widen, which means that the real (inflation adjusted) wage rate is growing exponentially (i.e. at an increasing rate).

Strictly speaking, wage determination remains under regulation, since the last Wage Guidelines that the Minister of Finance issued to the Industrial Court in 1994 are still in force. The Guidelines stipulate:

- full inflation (i.e. 100 per cent) compensation of the Revised Lower Income Group Nairobi CPI for the low wage earners, and a decreasing percentage to higher wage earners (with a view to reducing overall wage disparity). This was not a radical departure from the previous Guidelines that also stipulated 100 per cent compensation for low wage earners, and a maximum of 75 per cent for higher wage earners.

- firm productivity levels achieved during the period under review. Reference to increased labour productivity in other occupations and sectors was explicitly disallowed. Previous Guidelines pegged productivity increases to economy-wide productivity.

- reference to the earnings of non-unionised labour identified as "lower non-wage earners, the lower non-unionised wage earners as well as the average small farmer in the rural areas."

- that wage contracts could be negotiated as frequently as required. Hitherto, the Guidelines stipulated that wage contracts registered by the Industrial Court would be binding for two years.

Effectively, there are two significant departures from the previous Guidelines. These are, first, the change of productivity parameter from aggregate (i.e. economy-wide) to firm-level productivity. The second is the change in frequency of negotiations. Third, a provision in the previous Guidelines

---

[14] The Capital Markets Act and the Restrictive Practices, Monopolies and Price Control Act are examples of how it was intended for liberalisation to have proceeded, linked with legal and institutional reforms.

stipulating that awards be spread over the life of the agreement was removed. Although these are significant departures, they do not explain the observed wage explosion. The cost of living provisions would mean that the average wage should not rise faster than inflation, since the Guidelines only allow full inflation compensation for the lowest wage earners. This leaves two alternatives that would be consistent with the Guidelines, neither of which is borne out. These are (a) productivity growth, or (b) increased earnings of non-unionised employees.

Firm level productivity data are not widely available. However, the Central Bureau of Statistics reports labour productivity growth in the manufacturing sector. These data contradict this possibility. In the five year period – 1997-2001 – labour productivity is estimated to have fallen 1.1 per cent cumulatively (i.e. -0.2% per year on average). During the same period, real earnings of manufacturing workers rose 48 per cent in the private sector, and 75 per cent in majority state-owned enterprises (SOEs), that is firms in which the Government has over 50 per cent share, which is 9.5 per cent and 15 per cent per year, respectively. It is highly unlikely that there are firms whose productivity was rising at this rate, and even more unlikely that labour productivity in SOEs would have risen faster than in private firms.

The second option (i.e. the possibility that the compensation of workers above the unionisation threshold is behind the wage escalation) is also not borne out by the data. Here also, we do not have the benefit of time series data on earning of workers at different levels. Moreover, the manner in which wages awarded in collective bargaining agreements are published is not particularly helpful, as only the new settlement is reported with no reference made to previous salaries. That said, the data do provide a very heuristic inference on the trend of compensation for unionised workers. In the period 1997-2002, the average pay awards registered by the Industrial Court increased by 19 per cent year on year, as compared to an annual inflation rate of 7 per cent. This suggests real wage growth in the order of 12 per cent per year, compared to 9 per cent national average. In effect, the earnings of unionised workers have increased at least as fast, if not faster than the earnings of those above the unionisation threshold.

Chapter Three

THE WAGE RATE AND ECONOMIC PERFORMANCE

In this section, we make observations on the implications of the real wage rate on the principal socio-economic objectives of economic policy, namely growth, employment and equity. We begin by reviewing the data, and then proceed to interpret these in the context of the impact of liberalisation broadly, and deregulation of wage determination in particular.

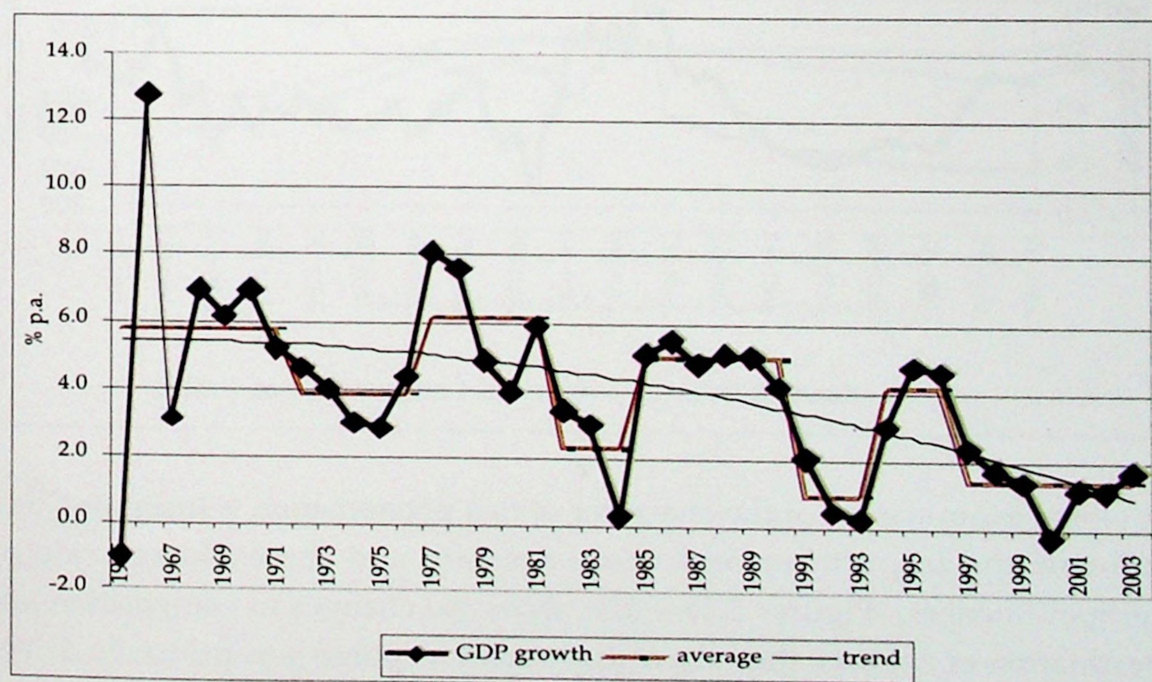
3.1 GROWTH

Competitiveness

Figure 3.1 shows the long-term growth performance of the economy. It shows two striking features. The first is the boom and bust nature of Kenya's growth. This is explained primarily by the economy's vulnerability to domestic and external shocks, both positive and negative. The shock events include oil price shocks (1973, 1979), coffee booms (1976/7, 1986), droughts (1984, 1992, 2000), a donor aid boom and bust (1987-90, 1993), as well as the adverse effects of Middle East wars, terrorism and counter-terrorism.

The second feature is a secular decline. A careful look at the graph reveals that each recovery from adverse shock is weaker than the preceding one, and in

Figure 3.1: Growth of the economy, 1965-2003

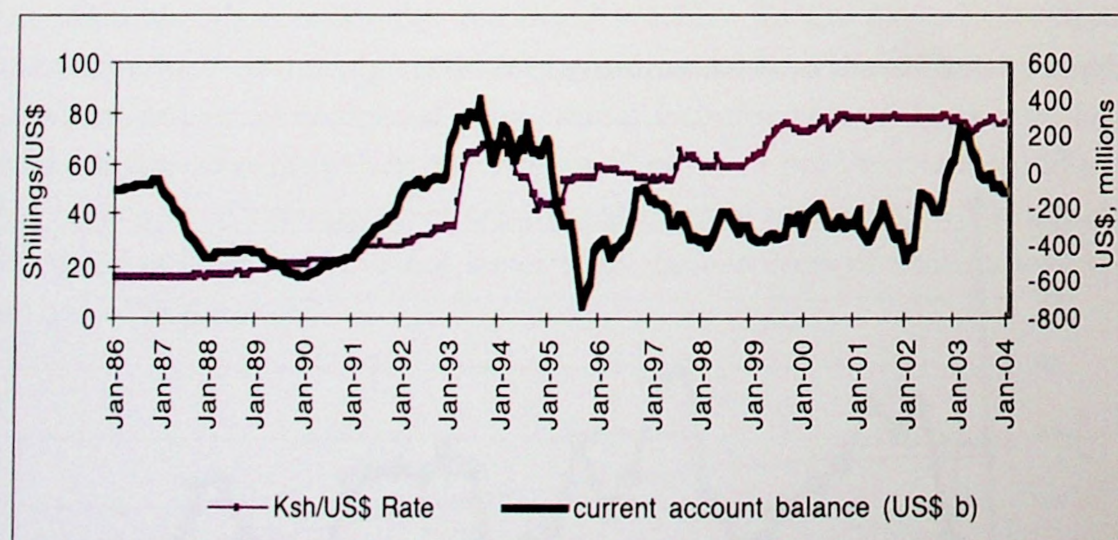


effect the weakening of the economy over time, a trend that spans both the pre- and post-liberalisation policy regimes. The most visible inference that might be drawn from this is that liberalisation has not had any positive impact on growth. This would be a misleading conclusion as it would require the support of a counterfactual (i.e. a prognosis) on how the controlled economy would have performed, all other things equal.

The buoyant growth episode (1995-97) provides a counterpoint. It was not supported by infusion of balance of payments support, and the period was normal in most other respects in that it is not associated with other windfalls such as the coffee booms.

The most plausible and indeed evident account of this growth episode is in fact a trade response to liberalisation. This we attribute to the effects of the removal of exchange controls, and the combined effect of floating the shilling and the inflation episode in 1992/93, on the real exchange rate and real wages. This can be seen in Figure 3.2; the trade balance (surplus of exports over imports) was deteriorating in the latter half of the 1980s. It began improving in 1990, and did so steadily until the end of 1992. Thereafter, there is a surge and the account remains in surplus until January 1995. With the exception of the 1976/77 coffee boom, this episode is the most favourable balance of payments in Kenya's post-independence history. The shilling/US dollar exchange rate is plotted alongside. It is evident that there is a strong co-movement between the trade performance and the exchange rate. The trade surplus comes to an abrupt end at the beginning of 1995. This follows a sharp appreciation of the shilling.

Figure 3.2: Impact of exchange rate liberalisation on the balance of payments



A closer examination of the character of this phenomenon is insightful, as it informs the impact between the wage rate and the exchange rate on competitiveness. Figures 3.3a - 3.3c show the changes in composition and destination of exports; they show that export response was primarily driven by exports of manufactured goods into the regional market. In effect, the

deregulation translated into both export growth as well as diversification. In value terms, annual exports increased by US$ 1 billion from US$ 1.1 billion to U.S$ 2.1 billion (i.e. just about double), from 1991 to 1996. Exports to the region contributed 75 per cent of this increase (i.e. US$ 765 million). In terms of diversification, the share of processed exports increased from 31 per cent in 1992 to a peak of 49 per cent in 1995, but has since fallen back to an average of 40 per cent. The share of exports destined to Africa more or less doubled over the same period, rising from 26 per cent to 49 per cent, and has remained well above 45 per cent. The close co-movement in Figure 3.3b shows that two trends are indeed the same phenomena.

Figure 3.3a: Composition of Kenyan exports by destination

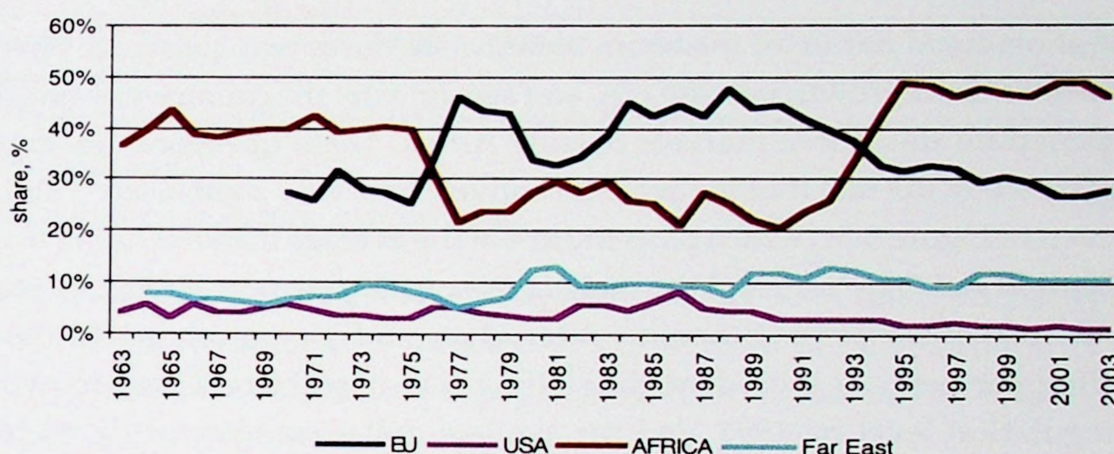


Figure 3.3b: Export shares: Africa processed goods

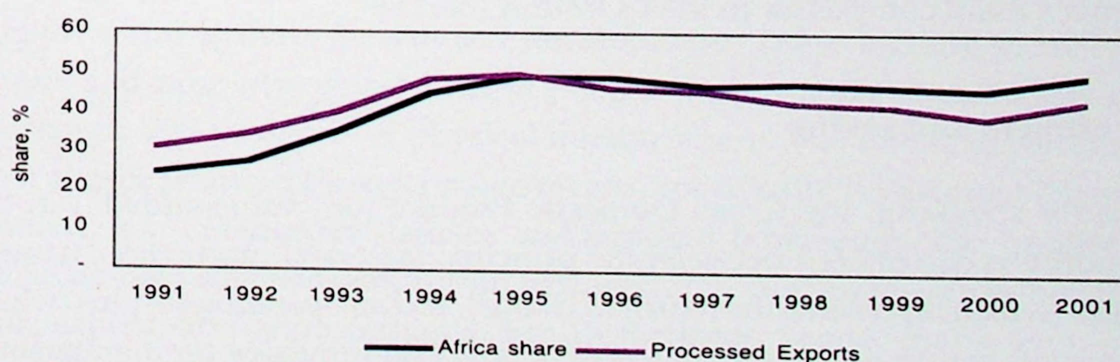
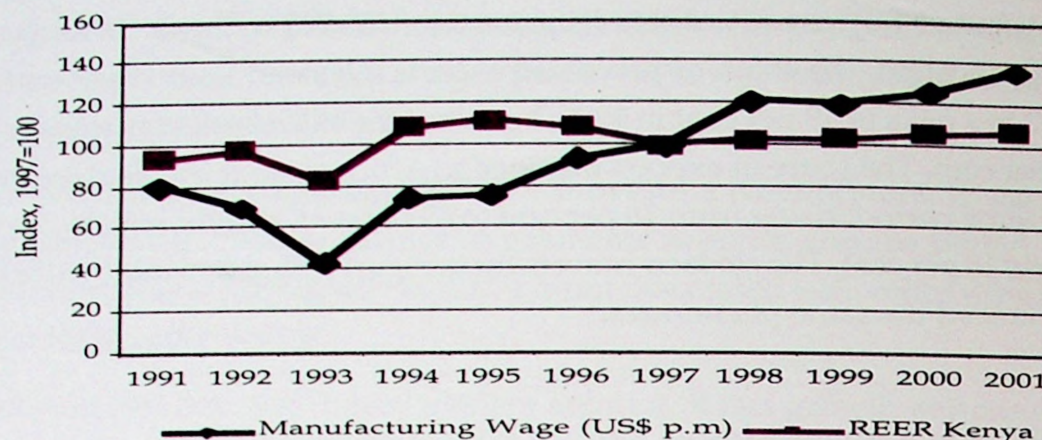


Figure 3.3c: Real effective exchange rate and manufacturing wage movements



The short-lived nature of the boom nonetheless raises two questions: First, is why the export growth petered out, and second why the country was not able to penetrate the global markets outside Africa. These questions are largely explained by the fact that the price incentives were very short-lived. This can be seen in Figure 3.3c, which plots indices of the average manufacturing wage, measured in US dollars and the real effective exchange rate (REER), which is a measure of the price competitiveness of a country's exports relative to its trading partners. As is evident, the shilling was, in real terms, back to its pre-deregulation level by 1994, and the average dollar-manufacturing wage in 1995. While the real exchange rate more or less stabilised since 1997, the dollar wage continued to rise. In actual values, the average manufacturing wage fell from US$ 120 per month in 1990 to US$ 63 in 1993, subsequently rising to US$ 250 as at the end of 2003. By way of comparison, in 1997, the average manufacturing wage (US$ 150) was 50 per cent higher than Egypt's (US$ 100), Kenya's main competitor in the COMESA market.

Investment and saving

Broadly speaking, the Gross Domestic Product (or "value-added") in the economy is distributed between the principal factors of production, namely wages (which represents the return to labour), and an operating surplus (which represents return to capital) inclusive of land and provision for maintenance and replacement of capital. In general, saving (and consequently investment) out of the operating surplus (by enterprises) tends to be higher than saving out of labour income (by households).

As shown in Table 3.1, the rapid escalation of wages is reflected in a reduction of the operating surplus by 10.5 per cent of GDP, from 59 per cent in 1997 to 48 per cent in 2003. This is in turn reflected in the steady increase in consumption, from 83 per cent of GDP to 92 per cent over the decade, and the corresponding decline in investment rate from 17 per cent to 13 per cent. The last column in

Table 3.1: Macroeconomic impact of high wage growth, 1992-2003

	% of GDP			Change, %		
	1992	1997	2003	1997/92	2003/97	2003/92
Factor incomes						
Labour cost	44.5	41.2	51.7	-3.3	10.5	7.2
Enterprises	26.7	26.9	34.6	0.2	7.7	7.9
Households	1.5	1.2	1.05	-0.3	-0.2	-0.5
Government	16.4	13.1	16.1	-3.3	3	-0.3
Operating surplus	55.5	58.8	48.3	3.3	-10.5	-7.2
Rental surplus	5.5	4.0	3.9	-1.5	-0.1	-1.6
Other operating surplus	50.0	54.8	44.4	4.8	-10.4	-5.6
Composition of demand						
Investment	17.4	18.6	12.9	1.2	-5.7	-4.5
Consumption	82.5	88.8	91.7	6.3	2.9	9.2
Public	16.2	16.2	17.9	0	1.7	1.7
Private	66.3	72.6	73.8	6.3	1.2	7.5
Total*	**99.90**	**107.37**	**104.6**	7.5	-2.8	4.7

**Difference between total and 100 per cent is the net resource flows from abroad (current account)*

Source: Economic Survey, various issues

Table 3.1 shows that the consumption increase has been financed partly by crowding out investment to the tune of 4.5 per cent of GDP and partly by resources from abroad (balance of payments deficit) to the tune of 4.7 per cent of GDP.

3.2 PROVISION OF PUBLIC GOODS

The purpose of public expenditure is to provide public goods needed to support social welfare, growth and development. These include security of people and property, investment in people (in particular, healthcare and education), and provision of physical infrastructure. The public expenditure must also be financed by sustainable means, specifically investment friendly taxation, non-inflationary deficits, and prudent borrowing. The quality of public services depends critically on balanced allocation of resources between staff, capital formation (schools, health facilities, roads, dams, etc), and complementary resources, which are primarily for operations (e.g. fuel, medicine, textbooks and chalk) and maintenance (of equipment, health facilities, roads, dams, etc). Inadequately compensated staff will lack the motivation to work, and often resort to absenteeism, moonlighting and corruption. On the other hand, if the operations and maintenance outlays are inadequate, wage outlays, even if adequate, are effectively wasted; for example, police officers who cannot patrol the streets for lack of vehicles or fuel, or health workers without medical supplies and working equipment in their clinics.

Appendix 1 provides an econometric analysis that shows a very strong relationship between the composition of government expenditure and growth of the economy. The analysis investigates the influence of compensation, O&M outlays, and capital accumulation on growth. It identifies relative compensation of civil servants (relative to other public and private workers), and O&M outlays per Central Government worker and per unit of capital as variables that have a very significant influence on growth. The results also show that the effect of expenditure allocation decisions made in the past (up to a four-year lag) have consequences on contemporary growth. In terms of magnitude, the relative compensation of civil servants relative to other public employees dominates the impact of O&M outlays. These findings suggest that motivated civil servants are the Government's most valuable resource, and by extension a very critical factor of production in the economy. They suggest also that proper utilisation of existing public capital stock (i.e. government facilities) is more productive than new investments. This can be summarised as the proposition that increased work effort and adequate O&M outlays are both necessary conditions for growth enhancing public expenditure, but neither of them is sufficient on its own.

Figures 3.4a - 3.4d show the trends of these variables over time, from which the following observations can be made in the light of the above findings:

(a) The most important variable (i.e. relative compensation of the Civil Service), has deteriorated steadily over the time.

(b) O&M outlays per worker increased very significantly in the 1990s (on account of staff reduction primarily), a period associated with poor service delivery and deterioration of physical infrastructure and government facilities. This paradox may be explained by the disincentive effects of inadequate compensation as reflected in Figure 3.4a and declining O&M/capital ratio, that is, the O&M outlays being spread over too many facilities as reflected in Figure 3.4c.

(c) A possibly very significant factor is an increase in the incidence of corruption, such as theft of supplies (e.g. sale of government drugs) and over-invoicing (of road maintenance contracts for instance). This analysis in effect lends credence to the perception that misallocation of government resources broadly defined to include unproductive workers, capital and corruption underlies the secular decline of the economy that was highlighted earlier.

Figure 3.4a: Average Civil Service wage relative to private sector

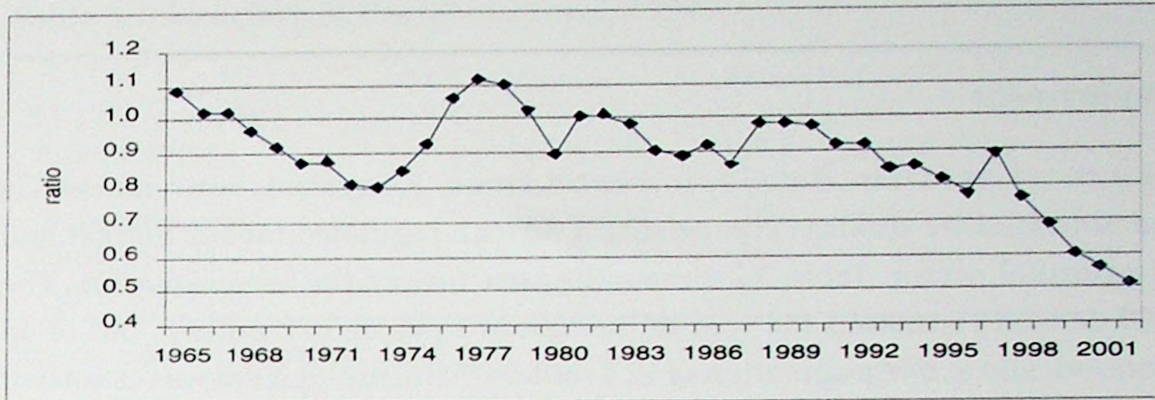


Figure 3.4b: Real O&M budget per civil servant, constant 1997 in shillings

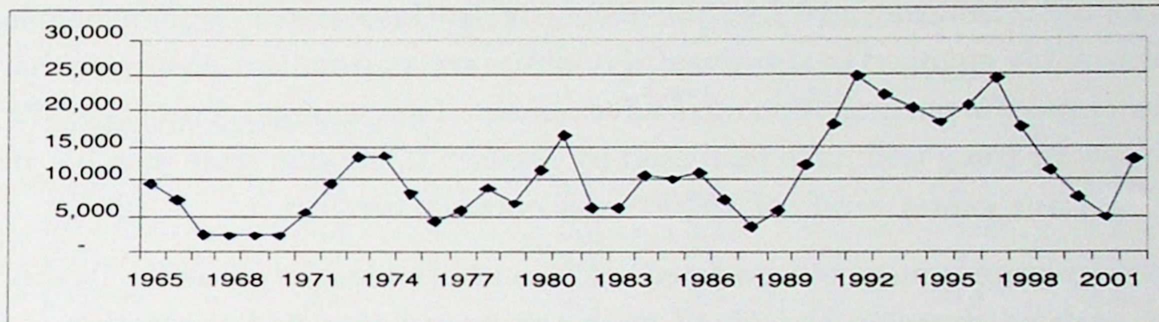


Figure 3.4c: Real O&M budget per unit of capital

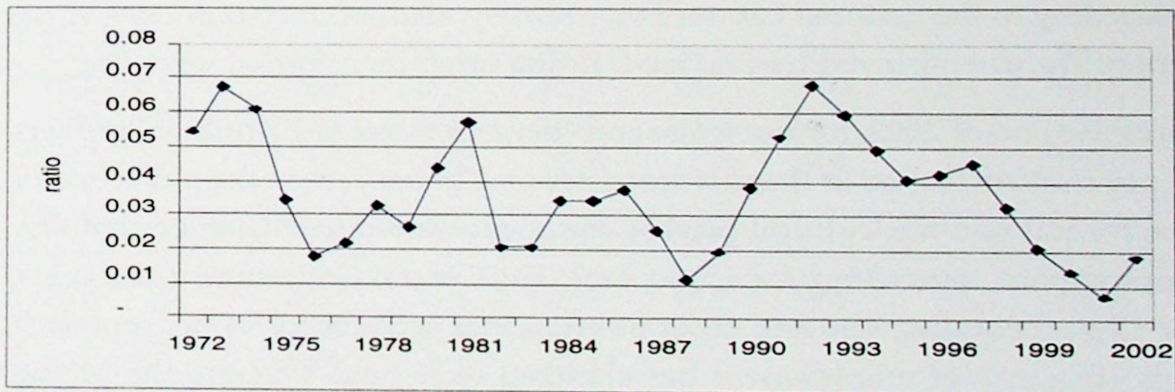
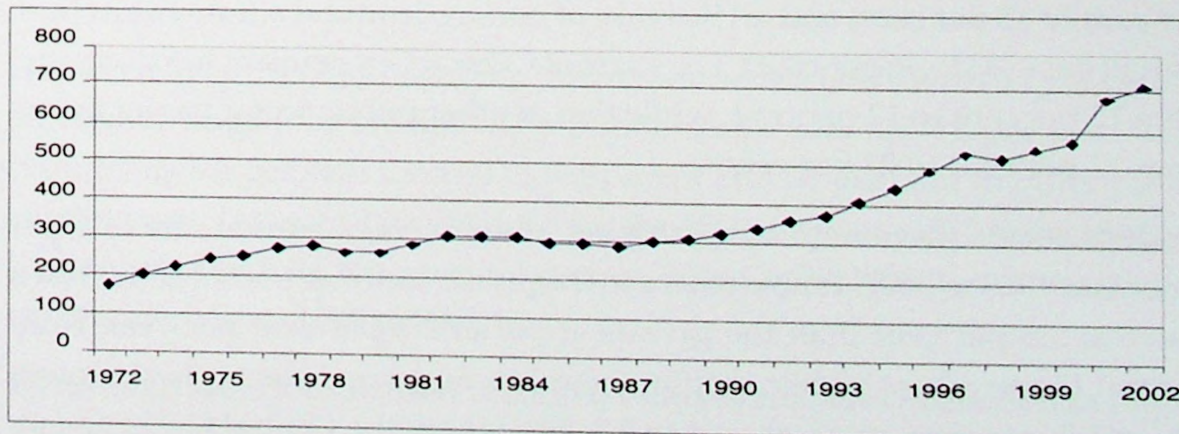


Figure 3.4d: Public capital stock per worker, constant 1997 in shillings



3.3 EMPLOYMENT AND INCOMES

Employment

Like most agrarian developing economies, Kenya's labour market is characterised by duality, comprising a formal, regulated labour market and an informal sector. Table 3.2 shows the structure of the labour market. The 1999 census estimated the size of the labour force at 10.2 million, out of an economically active population of 12.4 million.[15] Unemployment was estimated at one million (an unemployment rate of 10 per cent). Employment statistics for that year put employment in modern establishments and the informal sector at 1.7 million and 3.7 million respectively. This leaves 3.7 million people presumably engaged in non-wage agriculture and pastoralism. Assuming that cohort specific participation rates have remained the same as reported in 1999, the labour force will have increased by another 1.7 million since then (i.e. in the last five years), a rate of 350,000 new entrants per year.

Open unemployment is associated with youth, and lack of job skills. Twenty per cent of those in the 15-19 year age group reported themselves as unemployed. This falls to 16 per cent in the 20-24 year age group and to 9 per cent and 6 per cent in the 25-29 and 30-34 year age groups respectively. According to the national Labour Force Survey, also conducted in 1999, 92 per cent of the unemployed had no job training other than formal schooling.

As at the end of 2002, formal wage employment stood at 1.7 million workers, 61 per cent employed in the private sector and 39 per cent in the public sector. The formal non-agricultural private sector accounted for 64 per cent of total employment, agriculture for 15 per cent. The Central Government accounted for 12 per cent; teachers and other public sector account for 14 per cent each. This structure of employment has changed over time. Overall, the private sector share has contracted from 67 per cent in 1965. This reflects the net effect of contraction of the share of agricultural employment from a larger base (35 per cent to 15 per cent) and an increase of non-agricultural employment from a small base (33 to 46 per cent). The share of Central Government has decreased from 15 per cent to 12 per cent, while that of other public sector has increased from 17 per cent to 27 per cent.

Modern sector wage employment grew at an average annual rate of 3 per cent from 1965 to 2002. Employment in the public sector as a whole has grown faster at 3.5 per cent than the private sector at 2.7 per cent per year. Non-Central Government public employment has registered the highest growth rate at 4.3 per cent, as compared to 2.3 per cent in the Central Government.

[15] Economically active population is defined as age bracket 15-64 years, and the labour force as those who report as working or available to work. It excludes those in full time education or unavailable to work for other reasons.

Table 3.2: Structure of the labour force, 1999

	Persons	Share (%)
Labour force	10,217,292	100.0
Formal establishments	1,753,800	17.2
Informal sector	3,738,800	36.6
Unemployed	1,038,276	10.2
Agric.& pastoralism (residual)	3,686,416	36.1

Source: Economic Survey, 2003

Table 3.3: Formal wage employment in Kenya, 1965-2002

	PRIVATE SECTOR			PUBLIC SECTOR			TOTAL
	Agric	Other	Total	Central Govt.	Other Public	Total	
Increase in employment (%)							
1965-73	-0.2	3.0	1.4	6.5	6.0	6.2	3.1
1974-85	-1.3	4.7	2.2	5.2	6.2	5.6	3.7
1986-91	1.3	4.1	3.3	1.4	5.4	3.7	3.5
1992-96	3.3	5.3	4.8	-3.6	1.4	-0.4	2.4
1997-2002	1.3	2.4	2.1	-2.4	-0.3	-1.0	0.8
1965-2002	0.7	3.9	2.7	2.3	4.3	3.5	3.0
Contribution to job creation (%)							
1965-73	10.2	28.1	38.3	28.5	33.2	61.7	100.0
1973-94	-1.0	48.7	47.7	15.7	36.6	52.3	100.0
1994-2002	22.2	92.9	115.2	-31.6	16.4	-15.2	100.0
1965-2002	4.8	53.1	57.9	9.5	32.6	42.1	100.0
Contribution to total formal wage employment							
1965	34.8	32.9	67.7	15.2	17.1	32.3	100.0
1973	29.0	31.8	60.7	18.3	20.9	39.3	100.0
1994	14.2	40.1	54.3	17.0	28.7	45.7	100.0
2002	15.1	46.2	61.2	11.5	27.3	38.8	100.0

Source: Economic Survey, various issues

However, in terms of job creation, the private sector leads with 53 per cent of all formal wage jobs created. The public sector created 42 per cent jobs, comprising 9.5 per cent Central Government and 33 per cent in other public employment. Separate data obtained for the TSC only from 1980 show teachers accounting for half the jobs created in non-Central Government public employment from 1980 to 2002.

Trend analysis of job creation in formal establishments is presented in Figure 3.5a; the analysis relates job creation to seven growth episodes as shown in Figure 3.1. Three key observations are evident from this analysis. The first is the downward trend in economic growth as discussed earlier. The second is the contrasting trends in public and private sector labour absorption. Public employment shows three regimes, a very rapid growth phase which ends at

the start of the 1980s, lower but still high growth in the 1980s, and contraction thereafter. Private sector employment on the other hand performed poorly in the 1960s, accelerated in the mid-1970s, and then slowed down in the latter half of the decade. It then accelerates steadily through the 1980s right up to 1996, and slows down sharply thereafter.

The third and arguably the most significant observation is the inverse relationship between private sector labour absorption and growth over the entire period. In the 1960s and 1970s, job creation in the private sector is well below the growth rate of the economy. In fact, private labour absorption is highest during the economic downturn that follows the first oil shock. Subsequently, private sector job creation outperforms the economy; it is unaffected by economic shocks of 1982-84 and 1991-93, declining only in the post-1997 economic stagnation.

Figure 3.5b sheds some light on the seemingly counter-intuitive relationship between private sector job creation and growth. It plots private sector labour absorption against the real wage. A clear inverse relationship is evident, in which the declining real wage is associated with accelerating labour absorption. The only anomaly is the early 1970s.

Figure 3.5c shows the breakdown of contribution to job creation between agriculture and non-agricultural private sector. With the exception of the tripartite initiative of the early seventies, formal agricultural wage employment contracted in the 1960s and 1970s. Thereafter, agricultural wage employment becomes a net job creator. This improves from the onset of liberalisation in the-mid 1980s. After full liberalisation in the early 1990s, the rate of job creation in agriculture more or less catches up, and moves in tandem with the rest of the formal private sector.

Overall, private sector labour absorption registers the best performance — close to 5 per cent — in the post-liberalisation regime. Both agriculture and the other private sector record the best performance on employment in this period, 3.3 per cent and 5.3 per cent growth respectively. The poor economic performance after 1997, which is reflected in declining labour absorption, is attributable to the loss of competitiveness occasioned by high interest rates, rising wage rate and real appreciation of the shilling. It is to be noted that despite negative growth in this later period, the economy performs better on employment creation than it did during the high growth regime from the mid-1960s to 1973, and just about the same as the controlled economy regime between 1973 and 1985.

The study draws two significant inferences from this analysis. First, external competitiveness is the critical link between growth and employment. Put differently, the sources of growth matters. Job creation by domestic absorption, by means of direct public employment, fiscal stimulus, or protection and/or

subsidies, is both inequitable and unsustainable. Second, to the extent that labour absorption in agriculture is pro-poor, this analysis provides strong evidence that macroeconomic competitiveness is critical for both job creation and poverty reduction.

Figure 3.5a: Labour absorption in formal wage employment

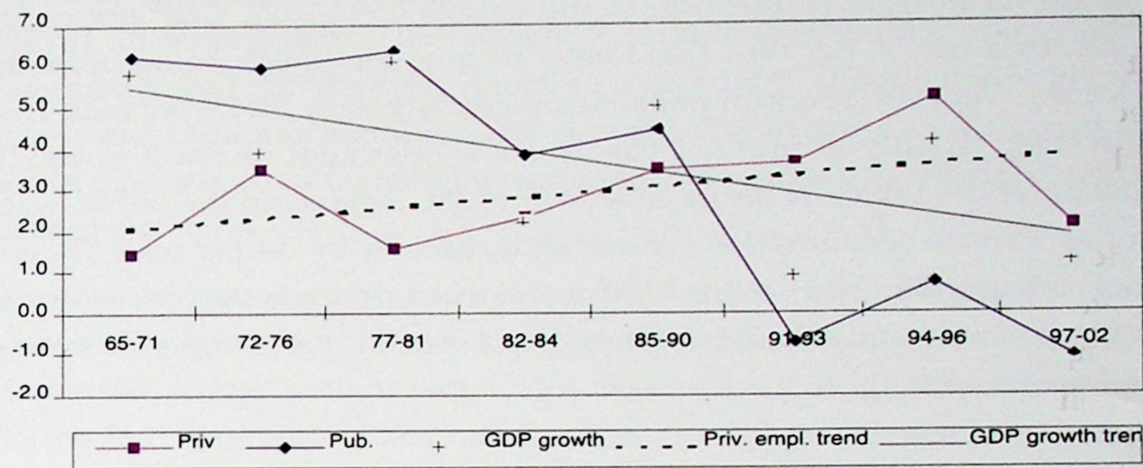


Figure 3.5b: Private real wage and employment growth, period average (%)

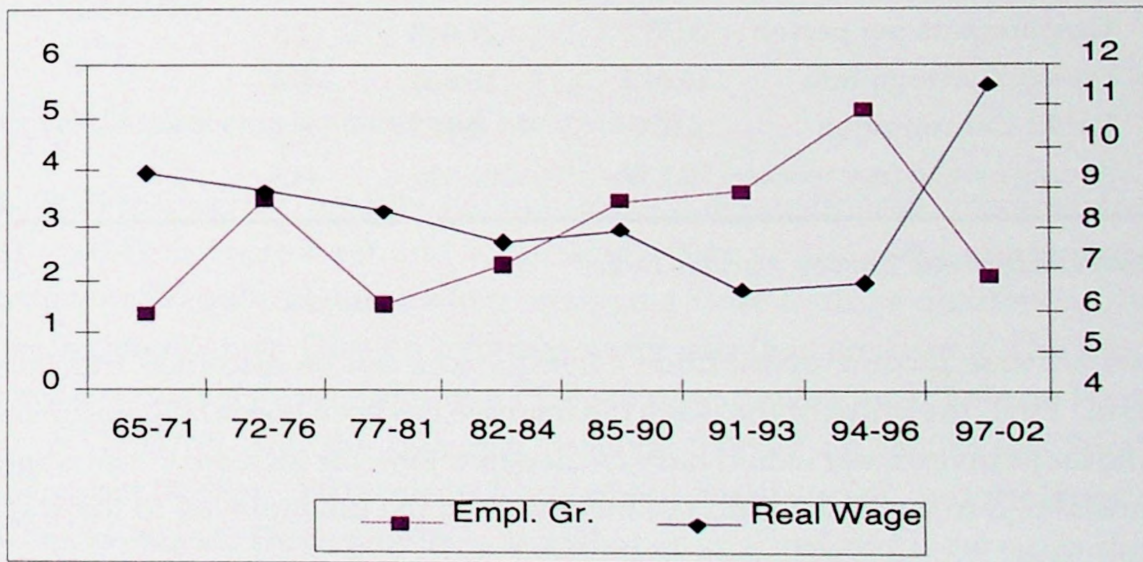
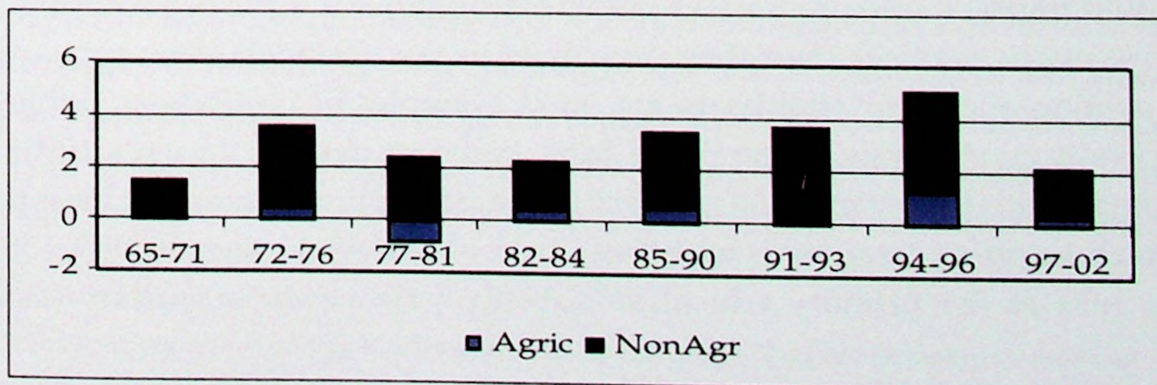


Figure 3.5c: Wage employment growth by source, period average (%)



Incomes

Equitable income distribution is one of the principal objectives of economic policy. In principle, increases in the real wage ought to reflect productivity growth in the economy. In turn, productivity growth is reflected in rising incomes. Much to the contrary, the real wage earnings in formal employment have risen against a backdrop of stagnant productivity at best, and declining per capita income (Table 3.4). In the decade 1992-2002, GDP per capita contracted by 7.7 per cent (i.e. Kenya became that much poorer over the decade). Per capita consumption increased marginally by 1.3 per cent. This, however, is fully accounted for by an 8.4 per cent increase in public consumption, which is also a reflection of the increase in the public wage outlay. Private consumption contracted marginally by 0.4 per cent. The fact that consumption has declined less than incomes reflects people's efforts to maintain their standards of living, which is of course to the detriment of savings and investment.

Table 3.4: Real incomes, consumption and wages, 1992-2002 (1997 shillings)

	1992	2002	change, %
GDP per person	25,189	23,250	-7.7
Consumption per person	20,771	21,047	1.3
Private Consumption	16,693	16,626	-0.4
Public Consumption	4,078	4,421	8.4
Average wage (per worker)	70,139	101,590	44.8

Source: Economic Survey, various issues

Two adverse income distribution consequences can be discerned from this trend. First, the brunt of the wage bill increase has been borne by investment. In so far as investment would have created new jobs, the increase in real wages translates into a redistribution of income from the unemployed to the wage employed.

Secondly, the increase in public consumption is itself likely to have a regressive effect on the distribution of income. In principle, a progressive tax system should translate into progressive public expenditures (i.e. the poor consume more public services than they contribute to tax revenues). Free primary education and basic healthcare are good examples of progressive public expenditure. Analysis by the World Bank, based on data for the early 1990s, estimated that the bottom 50 per cent of the population in terms of income (which broadly corresponds with those below the poverty line), received 55 per cent of the primary education subsidy.[16] However, secondary and

[16] Kenya Poverty Assessment Country Report 1994

university subsidies were found to be regressive (i.e. the non-poor benefitted more than the poor).

That said, the situation where increase in public consumption is driven by increases in wage outlays without commensurate increase in, and in some cases at the expense of, complementary expenditures, it is bound to be regressive. This is reflected in the deterioration of the public infrastructure and development indicators, school enrolment, child mortality and public security to name a few. The burden of undelivered public goods falls disproportionately on the poor, directly, on account of their inability to pay for private healthcare, education and security, and indirectly on account of the fact that self-provision costs by businesses are reflected in higher prices of goods and services.

These adverse income effects explain why, despite rising wages, the vast majority of wage earners have not perceived tangible improvements in their standards of living. In aggregate, an increase in wage incomes alongside an increase in the unemployment rate translates to a higher dependency ratio, which is reflected in the fact that consumption per capita has not increased. In addition, a proportion of the additional earnings have gone into paying for hitherto publicly provided goods — security, education, healthcare, water — as well as the cost of poor infrastructure such as high transport costs, generation, etc.

Informal sector employment and incomes

The informal sector, broadly defined to include small-scale farmers and pastoralists, own account and wage employees in non-farm enterprises, dominates Kenya's labour market, occupying close to three-quarters of the working population. Data on informal sector earnings are scarce. The most recent data available are from two 1999 surveys: the National Labour Force Survey 1998/99, and the National Baseline Survey on Micro and Small Enterprises (MSEs). The former is à household-based survey, and the latter is enterprise based. These provide a snapshot of informal sector earnings that can be readily compared with formal sector earnings.[17] From these two surveys, features of informal sector earnings are noteworthy. First, the livelihoods afforded by informal sector workers compare very favourably with the private sector, as can be seen from the data on household expenditure by occupation of household head shown in Table 3.5. Second, micro and small enterprises pay competitive wages in relation to the statutory minimum wage, as can be seen in Table 3.6, and entrepreneurs incomes are comparable to the wages they pay. While the wages are considerably lower than the average in

[17] Previous informal sector studies arrived at estimates that are broadly consistent with these data.

the formal private sector at the time, it should be borne in mind that the vast majority of the MSE wage earners are predominantly young and in the low skill occupations.

From these observations it can be inferred that the informal and formal labour markets are in fact well integrated. This case is more persuasively made by the similarity of the household expenditures at every level of education. The fact that the informal sector is as close to a perfectly competitive market as is conceivable begs the question as to why, in the context of high unemployment, informal sector employers pay competitive wages. The similarity of owners and employees earnings provides an indication as to why. Economic theory predicts that in a perfectly competitive market, the market-clearing wage will be equal to the value of a worker's production (i.e. the value of marginal product of labour). Salient features of the sector, the ease of entry and limited product differentiation lend credence to this prediction (i.e. workers can easily set up their own enterprises). This means that owners do not have much bargaining power over workers, unemployment notwithstanding.

A tentative conclusion that can be drawn, subject to validation by more rigorous analysis, is that the informal sector, and self-employment in particular, is the wage setter in the private labour market. This hypothesis is consistent with the responses given by MSE owners for starting a small business (Table 3.7). Close to 40 per cent of owners cited better income prospects and preference for self-employment, and well over 60 per cent of the reasons that can be termed as choice as opposed to circumstance (numbered 1 to 6 in the Table). Only a third cite lack of alternative, which is to say unemployment. In absolute terms, the 40 per cent translates to 670,000 workers, equivalent to 38 per cent of wage employment in formal establishments at the time. It is a reasonable presumption that the majority of those who venture into self-employment with the expectation of better income prospects are of above average ability. It follows that formal private establishments have to pay a premium to retain skilled, enterprising workers.

Table 3.5: Mean monthly household expenditures by education and employment of household head (Kshs)

Age/Education	Public	Priv. (formal)	Informal	Informal ratio to:	
				Public	Private
None	5,488	2,972	3,071	0.6	0.97
Primary	5,908	4,032	4,174	0.7	0.97
Primary + training	7,254	4,580	4,299	0.6	1.07
Secondary	9,358	7,240	7,094	0.8	1.02
Secondary + training	9,932	7,795	7,320	0.7	1.06
Undergraduate	14,836	18,700	23,525	1.6	0.79
Postgraduate	27,063	48,098	43,240	1.6	1.11

Source: National Labour Force Survey 1998/99, CBS

Table 3.6: Mean monthly earnings in micro and small enterprises, 1999

	Owners (Kshs)	Employees (Kshs)	Ratio of wage to minimum wage
Manufacturing	4,869	3,771	1.6
Trade	4,370	7,852	3.3
Services	15,730	13,130	5.6

Source: National MSE Baseline Survey 1999 (CBS, ICEG & K-Rep)

Table 3.7: Reasons cited for starting a small business by MSE owners

Main Reason	% citing	% cumulative	Implied no. of owners*
1. Better income prospects	26.0	26.0	436,763
2. Preference for self-employment	13.7	39.7	230,141
3. Skilled in activity	6.6	46.3	110,871
4. Availability of capital required	7.1	53.4	119,270
5. High demand/ready market	5.7	59.1	95,752
6. Family worked in this activity	3.9	63.0	65,514
7. Advised by others	2.9	65.9	48,716
8. Advertisements	0.2	66.1	3,360
9. Other	0.8	66.9	13,439
10. No alternative	32.7	99.6	549,314

Based on " per cent citing" and estimated number of MSE owners

Source: MSE Baseline Survey

Chapter Four

PUBLIC SECTOR PAY

This chapter deals with the specific question of compensation in the public sector and begins by reviewing the performance of institutions. This is followed by an evaluation of compensation in the public sector vis-à-vis the labour market, and in relation to regional and international public pay norms, with reference to the questions of adequacy, equity, affordability and sustainability of wages in the sector.

4.1 PAY DETERMINATION: INSTITUTIONS AND POLICIES

In all economies, wage determination is by far the most institutionalised market; that is, wages are the outcome of institutional arrangements and processes, as opposed to demand and supply in the free market. As a result, the wage rate is typically the least flexible of the principal macroeconomic prices. Many institutions, actors and processes are involved in the determination of pay in the public sector.

Broadly, these fall into three categories:

(a) Administrative reviews (by commissions, task forces and committees),

(b) Collective bargaining agreements (CBAs), and

(c) Executive discretion.

Administrative reviews

Salary review commissions have been the customary method of determining the terms and conditions of employment in the public sector. There have been fourteen such commissions since Kenya's independence. Table 4.1 provides a listing of the commissions and their purpose. A close look shows that commissions have become more frequent and less comprehensive in scope over time. Four commissions were appointed from independence to 1980, two in the 1980s, and 8 in the 1990s. As regards scope, all but one (Millar-Craig, 1967) that sat up to 1980 were tasked with fairly comprehensive mandates that covered the entire public service.

Subsequently, the commissions fall into two categories, namely, those concerned with the core Civil Service and those tasked with specific services. The Ramtu (1985), Mbithi (1990) and Munene (1997) Commissions addressed themselves to the core Civil Service. The services which have received special attention are the uniformed services (i.e. Kenya Police, Kenya Prisons and National Youth Service) by Ominde (1987/88) and Ng'eny (1996/97) Commissions; Judiciary by Kotut (1992) Commission, National Assembly by Nyakiamo (1996) Commission; and public universities by Mwakio (1997)

Commission. This fragmentation culminated in the appointment of the Kipkulei Commission (1998/99) which was tasked to harmonise the anomalies that had resulted.

Table 4.1: Public pay review commissions and committees since 1960

Year	*Chair*	*Scope of Work/Terms of Reference*
1960	*Sir Gilbert Fleming*	*Review terms and conditions of service of colonial officers in the public services of the East African Territories and the East African High Commission*
1963	*L.J. Pratt*	*Review structure of salaries of Civil Services, teaching staff and public sector*
1967	*H. Millar-Craig*	*Civil Service salaries review with specific reference to professional and technical personnel*
1970/71	*D.N. Ndegwa*	*Comprehensive review of public service structure and remuneration*
1979/80	*S.N. Waruhiu*	*Civil Service salaries, with specific reference to harmonisation with other services and the private sector.*
1985	*T.J. Ramtu*	*Civil Service. Specific focus on development of schemes of service for all civil servants*
1987/88	*S.H. Ominde*	*Police and Prisons officers*
1990	*P.M. Mbithi*	*Civil Service*
1992	*E. Kotut*	*Judiciary*
1995	*W.O. Omamo*	*Local authorities*
1996/97	*K. N'geny*	*Police and National Youth Service*
1996	*P. Nyakiamo*	*National Assembly*
1997	*P.M. Munene*	*Civil Service*
1997	*E. Mwakio*	*Public universities staff*
1998/99	*B.K. Kipkulei*	*Civil Service. Specific focus on harmonisation of pay*

The policy and practice of reviewing pay through *ad hoc* commissions has been the subject of numerous and repeated criticisms over the years, not least by the commissions themselves. The recurrent theme in these criticisms is weak political ownership of the reports, which has led to selective adoption and implementation of recommendations. The general pattern has been one where recommendations of direct benefit to employees have almost invariably, been adopted and implemented, while those of public interest, and in particular, those relating to improvement of performance, have more often than not been ignored.

One of the most poignant illustrations of selective implementation comes from the Ndegwa Commission. Arguably the most ambitious, the Commission was tasked to review both the structure of Government and pay of the entire public service, and made far-reaching recommendations on these as well as on

governance and performance management. However, in the public imagination, and indeed in official and academic discourse, the Commission is perhaps best remembered, and blamed, for having legitimised public servants engagement in private business. Much less remarked is the fact that it made very far-reaching recommendations regarding conflict of interest. These included full disclosure of private interest, and prior approval where necessary; wealth declaration; and establishment of an Ombudsman. It is noteworthy that these recommendations were in the spirit of the recently enacted anti-corruption and public officers ethics legislation (see Box 1 at the end of this section for excerpts from the Report). As was to become the tradition of commissions, the remuneration recommendations were adopted and implemented but these ethical and other performance-related recommendations did not see the light of day.

On the same theme, the Waruhiu Commission, constituted a decade later, recommended the introduction of a Code of Ethics alongside a comprehensive revision of the Civil Service Code of Regulations. It also proposed the establishment of a permanent pay review body. The salary review recommendations were adopted and implemented. Five years later, the Ramtu Commission echoed the same recommendations. It went further to recommend the establishment of an Implementation and Monitoring Unit to be placed under the Office of the Chief Secretary. Once again, the remunerative recommendations were adopted, but the reform proposals were not pursued.

The most recent demonstration of this self-serving approach is to be seen in the implementation of the Kipkulei Commission proposals. The Commission recommended consolidation of the salary scales in the Civil Service from 23 job groups into 7 bands, decompression of the pay structure, rationalisation of allowances, and phasing out of some allowances. It also proposed a limit of allowances to no more than 20 per cent of basic pay. Following the Commission's report, an implementation task force was constituted. The task force proposed modifications of the pay scales and awards recommended by the Commission. The task force's proposals were published in the form of a draft Sessional Paper. In 2001, elements of the salary adjustments were implemented selectively. For the top band in the new structure, the Commission had proposed a salary scale of Kshs 140,000 - 531,000 p.m. The Task Force amended this to Kshs 154,350 - 291,050 p.m. When it came to implementation, it is the Commission's proposal that was awarded. Moreover, the salary increase was implemented by means of adjusting house allowances. Entertainment allowances for top civil servants were also increased significantly. In effect, the "implementation", if it can be so called, changed the compensation mix in the opposite direction of the Commission's recommendations.

Collective bargaining

The degree of unionisation in the public sector is considerably higher than in the formal private sector; available data on union membership only provide a rough approximation of this degree. Total union membership stood at 531,814 in 2001, equivalent to 31 per cent of people in formal wage employment. Just over half of the membership can be identified as public sector workers, equivalent to 41 per cent of total public sector employment, and 58 per cent excluding the Civil Service which was not unionised at the time. The Kenya National Union of Teachers (KNUT), which represents teachers in public employment, is by far the largest union in the country, accounting for 35 per cent of total union membership in 2001, representing 80 per cent of the employees of the Teachers Service Commission. The Local Government Union was the third largest, accounting for 9 per cent of total union membership, representing 58 per cent of the local government workforce.

World over, the labour movement constitutes both a market institution and an influential, often partisan, political constituency. The combination of the one party and the wage control regimes limited the exercise of political influence on wage determination. In 1979, the Kenya Government banned the Civil Service Union and progressively co-opted the labour movement into the ruling party.[18] In effect, the confluence of political liberalisation of politics and deregulation of the labour market in the early 1990s ushered in an unprecedented industrial relations regime in Kenya. It would appear that not only did policy makers not anticipate the implications at the time, but also they are yet to come to fully appreciate the consequences.

The long running saga of teacher's salaries amply demonstrates both the dynamics of this new industrial regime, as well as the Government's lack of preparedness. In the run-up to the 1997 elections, the Government entered into negotiations with the KNUT on teacher's salaries. It accepted and signed an award that was clearly unaffordable, and which was to be implemented in three stages spread over two years. The implementation of this award was to become the most protracted industrial dispute in Kenya's industrial relations history, as well as a thorny political issue throughout the Government's term of office. The first instalment was implemented a few months before the elections. After the elections, the Government promptly reneged on the settlement on the grounds that it was unaffordable. Negotiations were reopened, and a 10-year implementation plan was agreed on. By the end of the term, four years and several strikes later, the second instalment under the

[18] COTU was established in 1964 to solve rivalry between two labour unions: the Kenya Federation of Labour and the Kenya African Workers Congress. The Government has since exerted informal influence in the appointment of the Secretary General; for example, the Government showed its hand in 1993 when COTU clashed with the Minister for Labour and the entire management team was replaced with a more politically acceptable one.

new settlement was yet to be implemented. Not surprisingly, the dispute was still festering in the run-up to the 2002 elections. The NARC coalition promised not only to implement the disputed settlement, but also to shorten the settlement period from 10 to 6 years.

This saga raises three critical questions. First, how did the Government concede to a commitment it could not honour? Second, did the KNUT not realise that the Government's commitment was not credible? Third, did the NARC coalition appreciate the implications of its campaign promise? In many ways the questions are rhetorical. The short answer is that good judgement and long-term interests (industrial peace, and fiscal responsibility) were suspended for short-term political expediency.

Executive discretion

Pay determination by executive discretion is a recent, growing and alarming phenomenon in the public sector. Historically, two institutional frameworks, namely, the Civil Service pay review process, operating under the Public Service Commission framework, and the State Corporations Advisory Committee framework have governed administrative pay reviews. The SCAC is a standing committee established under the State Corporations Act to advise the Government on the compensation and performance of State Corporations. However, until its revival by the current Government, the Committee has not been in existence since 1990, when the term of the previous one expired. The Government neither renewed its term, nor did it appoint a new Committee.

This "third column", which is termed here as *executive discretion*, emerged in the early 1990s, and has continued to grow in prominence with highly adverse consequences. It began with the exemption of enterprises that were slated for privatisation from sections of the State Corporations Act. The purpose of the exemptions was to enable these corporations to operate like private sector entities. Once precedent was established, and compounded by the failure of the Government to appoint a SCAC, various reasons were found to exempt other parastatals, and to establish new public entities outside of the purview of the Act. Examples of these include the Kenya Wildlife Service; Kenya Anti-Corruption Authority (KACA) and its successor, the Kenya Anti-Corruption Commission (KACC); the Constitution of Kenya Review Commission (CKRC); the Kenya Institute for Public Policy Research and Analysis (KIPPRA), and the National Aids Control Council.

Aid agencies have been key drivers in, and in several instances insisted on, the establishment of these autonomous agencies, and underwrote premium compensation for the chief executives and senior staff. The precedent was in fact set with the Kenya Wildlife Service, which was established under a World Bank funded project. Once the donor funding dwindled, the KWS was unable to sustain the salaries. Over time, the compensation of top management of

these organisations has become an upward spiral that defies economic logic and, it has to be said, common sense as well.

Box 1: Excerpts from the Ndegwa Commission Report (1971) on Public Servants and Private Business

The Opinion:

So long as the [above] ***principles*** *are observed and subject to the* ***proviso*** *which follows, there ought* ***in theory*** *(our emphasis) to be no objection to the ownership of property or involvement in businesses by members of the public services to the point where their wealth is augmented perhaps substantially by such activities. But in common with many other African countries, the achievement of independence in Kenya has brought with it great opportunities for individual advancement both as to main careers and in other less orthodox ways. It is understandable that public servants should have taken their opportunities like other citizens but if the benefits in some cases seem to be out of proportion with other citizens it is inevitable that questions be asked as to how this has come about.*

The Principles:

THAT all public officials:

(i)should give it their undivided loyalty wherever and whenever it has a claim to their services

(ii)should not subordinate their duties to their private interests nor put themselves in a position where there is conflict between their duty to the State and their private interests

(iii)should not outside their official duties be associated with any financial or other activities in circumstances where there could be suspicion that their official position or official information available to them was being turned to their private gain or that of their associates

(iv)should not engage in any occupation or business which might prejudice their status as members of a public service or bring any such service into disrepute; and finally

(v)should at all times maintain the professional and ethical standards which the nation expects of them in transacting Government business with efficiency, integrity and impartiality

The Proviso:

The Government Code of Regulations contains a Section which lays down the rules of conduct which are in general consistent with the principles we have stated. The essence of these rules is that officers acquiring certain private interests should bring them to the notice of higher authority and where appropriate seek approval of their actions; we regard it as essential that these provisions which were in fact designed to protect the individual Civil Servant should be rigorously observed. We have the impression that this has not always been the case in the past and if this is so we suggest that the Government should consider requiring at some specific future date that all senior officers should make a complete statement of their interests as required by the amended Rules on the basis that failure to have done so hitherto will not itself count against them (pg.14).

The Recommedation:

[We recommend] the urgent appointment of an Ombudsman in Kenya as a means of preventing the abuse of power by Civil Servants…The evidence adduced before us during our inquiry indicates that a real need exists for the appointment of an Ombudsman in Kenya. Serious allegations regarding tribalism, nepotism, corruption and other forms of malpractice were made against Civil Servants and other public servants. We feel that these allegations, if not heeded and investigated impartially, could undermine the integrity of the Government and adversely affect public confidence and the morale of the public services…[The Ombudsman should be] a highly qualified and authoritative institution, with powers of access to all official files and powers to question all public servants and any member of the public which can receive and investigate any bona fide allegation that an abuse of power or improper use of office has occurred. This must be coupled with an obligation to make a public report on all such investigations, and if necessary, to refer such reports to the proper quarters (including, where appropriate, the public service commission or the Attorney-General's Office) for action (pg. 24).

4.2 WAGE TRENDS IN THE PUBLIC SECTOR

Figure 4.1 shows the evolution of the real (i.e. inflation adjusted) average wage in formal employment, in the public and private sector from 1967 to 2003. The values are presented in constant 1997 shillings (i.e. in 1997 purchasing power equivalent). For purposes of comparison with the public sector, the private sector refers to modern non-agricultural wage employment. The public sector is broken down into Central Government and other public sector, where the latter includes state corporations (fully owned and majority owned enterprises and statutory bodies), local authorities and teachers. With the exception of the Central Government wage, which has stagnated since 1997, the real public and private wage have moved in tandem for the entire period under review.

The overall trend reveals three distinct regimes as follows:

(a) a moderate growth regime pre-1974,

(b) a declining real wage regime from 1973 to 1993, and

(c) a rapid wage growth regime after 1994.

Figure 4.1b shows the trend within the public sector. This disaggregation shows that wage escalation has been most rapid in the parastatals, more so in the majority state-owned enterprises, followed by other state corporations, local authorities, teachers and the Central Government in that order. This pattern reflects the extent of wage setting independence, as discussed in the preceding section. As a result, wage gaps across the public sector are wider than ever before, and increasing. At the end of 2003, the average wage in majority state-owned enterprises was three times the average Civil Service wage.

The trend and its impact on real earnings in the private and public sector are summarised in Table 4.2. The regulated regime saw steady erosion of real wages in the economy. This was worst for non-Central Government public employees, at a rate of 2.8 per cent per year and least for Central Government at 2.2 per cent per year. Earnings in the private sector declined by 2.4 per cent per year on average. The effect was to restore the relative earnings of the Central Government employees to 80 per cent of the average private sector, and a premium of 8 per cent over other public sector workers. In purchasing power terms, however, Central Government workers' earnings were in 1994 just over half (53%) of the 1973 level, and 44 per cent of what they were in 1965. Employees in the other public sector were the most affected; their purchasing power in 1994 was 43 per cent and 36 per cent of the 1973 and 1965 levels respectively. In the private sector, purchasing power in 1994 was 56 per cent and 50 per cent of the 1965 and 1973 levels, respectively.

Figure 4.1a: Real wages in the private and public sector, 1967-2003

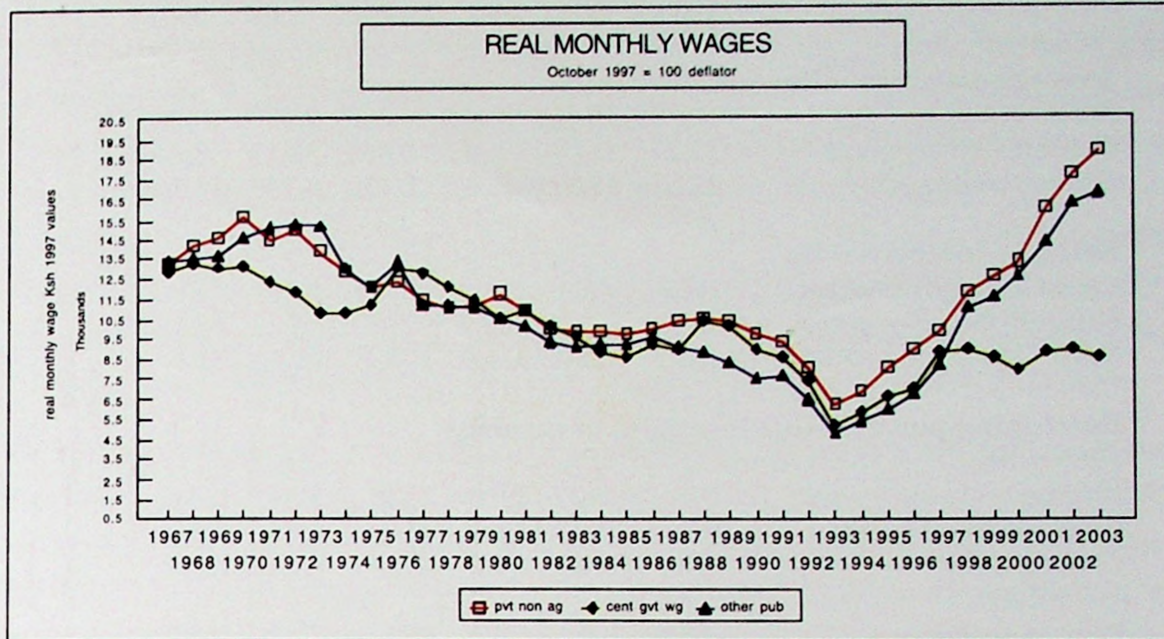


Figure 4.1b: Wage trends in the public sector, 1967-2003

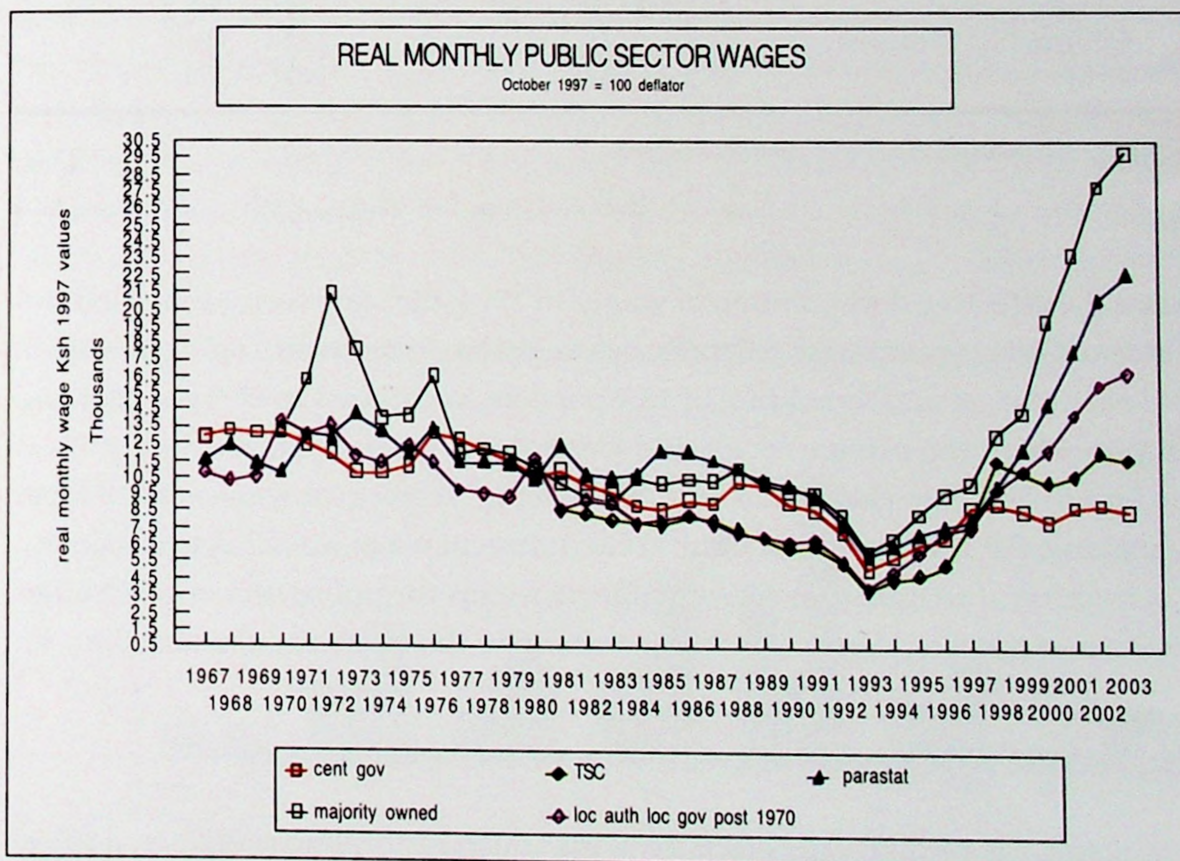


Table 4.2: Real wage trends in Kenya, 1965-2003

	1965	1973	1992	1994	1997	2003
Average earnings, KShs pm, 1997 prices						
Private sector	12,309	13,863	8,122	6,880	9,899	18,885
Central Government	13,252	11,086	7,432	5,865	8,813	8,646
Other public sector	12,688	15,171	6,499	5,410	8,190	16,765
Relative compensation						
Cent.Govt/priv. sector	107.7	80.0	91.5	85.2	89.0	45.8
Other Pub./priv. sector	103.1	109.4	80.1	78.6	82.7	88.8
Cent, Govt/other public	104.4	73.1	114.4	108.4	107.6	51.6
Purchasing power (value loss/gain) of earnings						
1965 = 100						
Private sector	100	112.6	66.0	55.9	80.4	153.4
Central Government	100	83.7	56.1	44.3	66.5	65.3
Other public	100	119.6	51.2	42.6	64.6	132.1
1973=100						
Private sector	88.8	100	58.6	49.6	71.4	136.2
Central Government	119.5	100	67.0	52.1	79.5	78.0
Other public	83.6	100	42.8	35.7	54.0	110.5
1992=100						
Private sector	151.6	170.7	100	84.1	121.9	232.5
Central Government	178.3	149.2	100	78.9	118.9	116.3
Other public	195.2	233.5	100	83.3	126.0	258.0

Source: Economic Survey, various issues

Since the effective deregulation of wages in 1994, the state sector that excludes Central Government and teachers has registered the most rapid growth in real earnings, at an annual rate of 13.4 per cent, compared to 11.9 per cent and 4.4 per cent in the private sector and Central Government, respectively. As at the end of 2003, private sector and other public sector real wage was 10.5 per cent above the 1973 level, but Central Government wage was 22 per cent below. It is important to note that recent wage increases for police officers and other sections of the Civil Service will have changed this picture substantially.

4.3 FISCAL CONSEQUENCES OF WAGE INFLATION

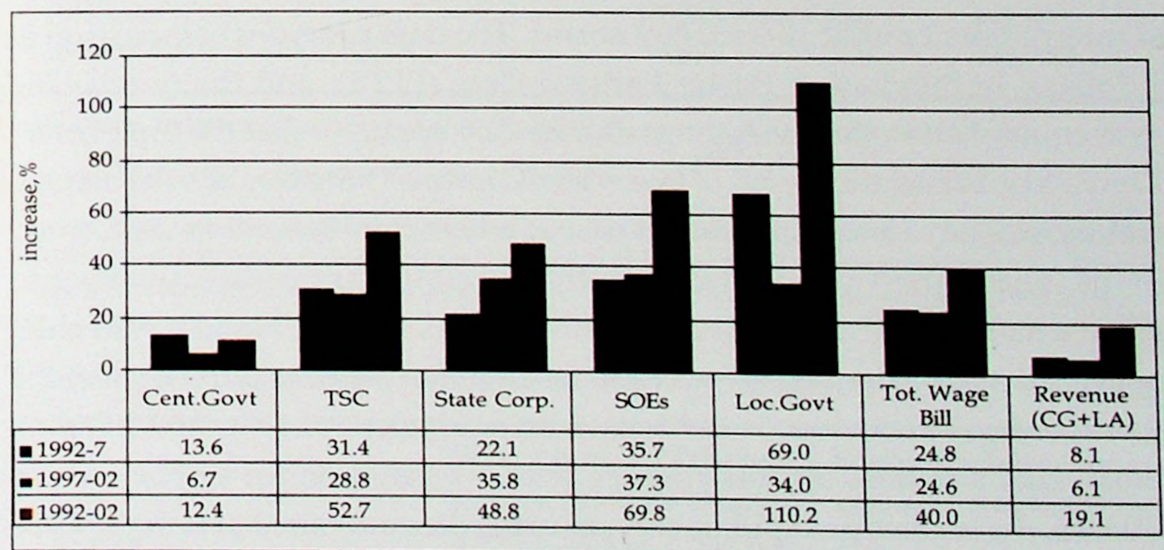
As a result, the public wage bill is growing much faster than revenues, a trend that is clearly not sustainable. The consolidated public wage bill grew from Kshs 66 billion in 1997 to stand at Kshs 161.3 billion in 2003, representing an increase of 144 per cent. Over the same period, the direct wage obligation of the Central Government, which comprises salaries of civil servants and teachers, grew from Kshs 39 billion to Kshs 75.6 billion, representing a 93 per cent increase as compared to a revenue increase of 63 per cent. Local government wage bill increased by 210 per cent from Kshs 7.9 billion to Kshs 24.6 billion, against a revenue increase of 97 per cent. The wage outlay of state corporations and enterprises increased by 220 per cent from Kshs 19 billion to

Kshs 61 billion. Although the revenues of state corporations are not available for comparison, it is doubtful that they are keeping pace.

The wage bill growth and its budgetary impact are depicted in Figure 4.2. In expenditure terms, savings have been generated from reduction in interest payments and Civil Service wage bill. These have been offset by increases in the teachers wage bill and transfer to parastatals and local authorities, hence the very modest increase in the share of O&M. The teachers wage bill increased from 12 per cent to 21 per cent of current expenditures, and transfers from 10 per cent to 17 per cent. The increased claim by transfers is a direct consequence of the unsustainable wage bill growth in parastatals and local authorities.

From the foregoing, it is readily apparent that the most immediate fiscal imperative is containment of transfers. This can be demonstrated as follows. If transfers had been contained at the FY91/92 expenditure ratio, the outlay in FY01/02 would have been Kshs 14 billion lower. This is equivalent to 35 per cent of the Central Government wage bill in FY01/02. It is also equivalent to the differential between average earnings of Civil Service and teachers. In effect, a hard budget constraint on parastatals and local authorities would have enabled parity between Civil Service and teachers pay. It should be noted that the actual transfers understate the extent of the problem. This is because of the practice where state corporations and local authorities finance their deficits by accruing debts that constitute contingent liabilities of the Government. These include pending bills to suppliers, pensions and other salary deductions such as staff contributions to their savings cooperatives.[19]

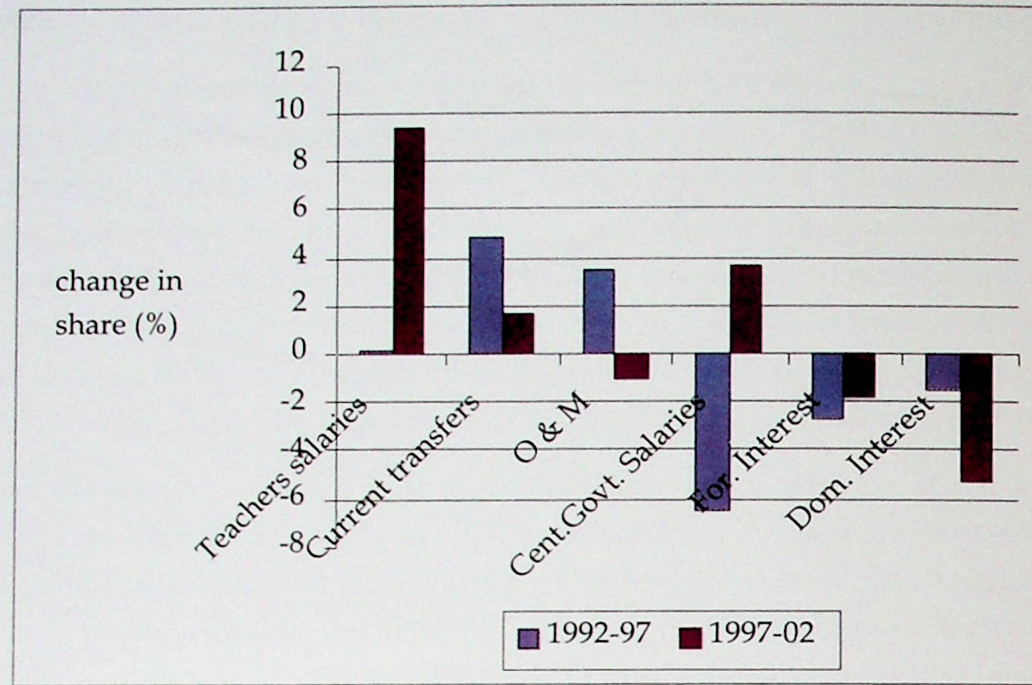
Figure 4.2a: Growth of the public wage bill, 1992-2002 (% increase)



	Cent.Govt	TSC	State Corp.	SOEs	Loc.Govt	Tot. Wage Bill	Revenue (CG+LA)
■ 1992-7	13.6	31.4	22.1	35.7	69.0	24.8	8.1
■ 1997-02	6.7	28.8	35.8	37.3	34.0	24.6	6.1
■ 1992-02	12.4	52.7	48.8	69.8	110.2	40.0	19.1

[19] This problem has been recognised and an exercise to determine the magnitude of these contingent liabilities is underway at the Treasury.

Figure 4.2b: Recurrent expenditure adjustments, 1992-2002



4.4 STRUCTURE OF PAY IN THE PUBLIC SERVICE

The previous section shows a remarkably close co-movement of average pay across the services, with the noted exception of the Civil Service since 1997. These averages mask gross disparities within and across the services. Comprehensive and comparable data on pay structure in the public sector are not readily available. In particular, there is very little information on the structure of pay in the parastatal sector. As such, the review in this section provides only a partial picture.

Table 4.3 compares compensation in the Kenyan public sector with regional and international public service pay norms. The data provides comparison in US dollars, in Purchasing Power Parity dollars (PPP$), and the purchasing power equivalent in Kenya shillings. It is readily apparent that the top earners in Kenya's public sector are out of line with the norm. The salary of a Permanent Secretary in Kenya is comparable to that of a Director-General in the United Nations. The highest pay in the mainstream public service is equivalent to one and a half times that of a UN Director-General, and the highest paid chief executive of a non-commercial parastatal is double. Looking at the region, the highest paid public servant is in Malawi, an equivalent of Kshs 300,000 p.m. In Botswana, a middle income country with a reputation for public service excellence, the highest paid public servant earns the equivalent of Kshs 200,000 per month.

The same picture is evident from an equity perspective. In terms of the ratio of lowest to highest paid, Kenya has the largest wage gap. The highest salary is 118 times the lowest, and 53 times the median wage. The regional norm is between 20 and 30 times the lowest and 4 to 9 times the median. In historical perspective, the highest salary in 1972 (as recommended by the Ndegwa Commision) was Kshs 7,640, which was 38 times the lowest (Kshs 200) and 6

times the median (Kshs 1,340). Adjusting for inflation to express these in current (2003) values, the highest salary is equivalent to Kshs 300,000, while the lowest would have been equivalent to Kshs 7,900 and the median to Kshs 52,900.

This study contends that this executive wage premium is in part responsible for the institutional inflation that has been characteristic of the public sector since independence. In this regard, a vested interest of the national elite to maintain a large public sector, or worse still, expanding it, is readily apparent. This, in our view, is a very fundamental public sector reform issue that the Government needs to confront.

Table 4.3a: Executive compensation, regional and international comparison

	Current US$	PPP(US$)	PPP(Kshs)
Kenya (2003)			
Highest paid public official	9,000	24,375	702,000
Permanent Secretary (approx.)	5,769	15,625	450,000
Parastatal CEOs (highest)			
Non-commercial	11,990	32,473	935,220
Commercial	17,070	46,231	1,331,460
Parastatal CEOs (average)			
Non-commercial	3,568	9,663	278,294
Commercial	5,922	16,040	461,944
All	4,078	11,046	318,122
Region (Highest paid public official)			
Malawi	3,403	10,406	299,693
Botswana	3,803	7,080	203,908
Uganda	1,108	3,933	113,282
Zambia	1,357	2,909	83,781
Tanzania	1,200	2,390	68,832
United Nations (Starting salary, gross)*			
Under-Secretary General**	15,512	15,512	580,769
Director (D2)	11,588	11,588	433,855
Senior Professional (P5)	8,675	8,675	324,792

**net salaries are about 70 per cent of gross, roughly the same as Kenyan after tax salaries*

*** second highest UN office after Secretary General*

Sources: Regional comparators data are cited from Pay and Benefits Conceptual Study (2002) by T.R. Valentine and F.W Maina conducted for Directorate of Personnel Management; Parastatal CEOs pay was provided by State Corporations Advisory Committee.UN salary scales are published on UN Website www.un.org

Table 4.3b: Public wage structure in the region, selected countries, 2002/3

	Salary p.m., PPP(Kshs)			Highest relative to:	
	Lowest	Median	Highest	Lowest	Median
Kenya	5,928	13,338	702,000	118	53
Malawi	2,730	3,963	299,693	110	76
Botswana	6,809	45,950	203,908	30	4
Uganda	4,499	19,630	113,282	25	6
Zambia	2,470	8,952	83,781	34	9
Tanzania	3,442	14,914	68,832	20	5
Kenya (1972)					
Current (2002) prices	7,897	52,909	301,659	38	6
Actual	200	1,340	7,640	38	6

4.5 ADEQUACY AND COMPETITIVENESS OF PAY IN THE PUBLIC SECTOR

The Labour Force Survey (LFS) conducted in 1998/99 provides details that allow comparison of wage structure in two broad ways: public compared with the private sector; and within each of these, wages for different occupations, education and location. The LFS was a nationally representative stratified sample survey covering more than 11,000 households. The data used in this section are averages for the working age (18-64 years) individuals engaged in formal employment and in public and private sector. This sub-sample has 2,509 observation of which 1,072 are urban and 1,437 are rural residents.

The structure of wage earnings in the economy is summarised in Table 4.4. The highlights can be readily observed: the private sector pays significantly more to the relatively skilled cadres whereas the public sector pays significantly more to the low skill occupations. The four higher level occupations, administrators/managers, professionals, technicians and clerical jobs are better compensated in the private sector, while the lower level occupations, service workers, skilled agricultural workers, craft workers, machine workers and elementary occupations (labourers, messengers, cleaners) are better compensated in the public sector.

Examining this proposition in more detail by looking at education, it is readily observed that the public sector has paid much higher salaries to those with less education and would therefore seem to have been paying salaries unrelated to educational qualification for those below university level. Notwithstanding these conclusions, it is noteworthy that the public sector pays more than the private sector on average in both rural and urban areas. Looking at public and private sector average wages paid in different industries, the average payments in the commercial areas of financial services and manufacturing are much the same in both sectors. In all three other identified sectors — health, transport and agriculture — the public sector pays a significantly higher wage.

These observed earnings gaps suggest that the public sector pays above market for at the lower levels and below market at higher levels, but this is not of itself sufficient evidence for this conclusion. This is because the qualifications that influence remuneration, education attainment, training and experience in particular, may differ systematically between the sectors. To draw conclusions in this regard, it is important to go beyond the averages and investigate whether indeed there are such systematic differences.

Table 4.4: Average earnings in private and public employment 1998/99 (Kshs p.m.)

Occupation	Public	Private
Administrators & managers	14,635	27 390
Professionals	21,597	28 008
Technicians	10,402	13 105
Clerks	7,994	9,778
Service workers	5,352	5,126
Skilled agricultural workers	7,997	5,491
Craft workers	10,084	6,844
Machine assemblers	7,308	7,110
Elementary occupations	4,557	3,462
Education		
None	7,256	3,067
Primary	5,817	4,285
Secondary	9,272	8,710
Undergraduate	20,141	27,030
Postgraduate	27,414	47,196
Industry		
Agriculture	7,620	4,035
Manufacturing	7,079	7,723
Transport	10,195	8,263
Financial	14,571	14,245
Health	12,101	8,732
Region		
Rural	8,623	4,916
Urban	11,142	10,354

Source: Labour Force Survey, 1998/99, CBS

Table 4.5: Earnings potential of public workers in the private sector, 1998/89 (Kshs p.m.)

Occupation	All public workers		Rural		Urban	
	Actual	Predicted	Actual	Predicted	Actual	Predicted
Admin. & managers	14,634	12,582	12,146	8,022	20,302	15,678
Professionals	21,597	15,522	12,185	9,045	27,016	22,026
Technicians	10,402	7,785	9,932	5,432	11,667	11,160
Clerks	7,994	7,943	7,349	6,503	8,525	8,955
Service workers	5,352	3,828	4,373	3,678	7,568	4,146
Skilled agric. workers	7,997	4,722	7,249	3,678	8,634	8,350
Craft workers	10,084	6,701	7,842	5,710	11,803	7,259
Machine assemblers	7,308	6,438	5,256	5,378	9,418	7,406
Elementary occupations	4,557	3,790	3,650	3,328	5,691	3,828

It turns out that, when qualifications are taken into account, public sector employees may in fact command less in the private sector job market than the earnings in the private sector. Specifically, the private sector puts a larger premium on education, while the public sector rewards experience. Table 4.5 shows the predicted average earnings of the public sector workers in the private labour market. The econometric analysis is summarised in Appendix 2. Overall, this analysis indicates that public sector employees earning potential

in the market is less than their compensation in the public sector. The estimated earnings potential range from 60 per cent of the actual for skilled agricultural workers to about actual for clerical workers. The exceptions are urban clerical workers and rural machine operators, whose market earning potential is estimated at 5 per cent and 2 per cent above their actual compensation, respectively. Public sector employees in the elementary occupations are predicted to have higher earnings potential in the market than the private sector wage for these occupations. This suggests that these occupations are overcompensated in the public sector, but the workers are undercompensated relative to their qualifications. Put differently, the high wage relative to the market at the lower levels attracts workers with better qualifications than those who are employed for similar work in the private sector.

4.6 PAY AND PERFORMANCE

The question of pay in the public sector needs to be addressed in the context of performance. Low morale, engagement in private business during working hours and corruption are known to be pervasive in the public service. To investigate this question, the sources of income, as reported in the Labour Force Survey, are compared for systematic differences between public and private sector employees. Indeed, systematic differences are apparent. Table 4.6, shows the income by source for employees both in the public and private sector, and by occupation.

The data provides two observations. First, non-wage income is a very significant source of income for both public and private sector employees, but public employees derive a much larger share of their income from non-wage sources than private sector employees. Second, the capacity to generate extra income declines with the level of education attainment, in effect with seniority. This pattern is less pronounced when the data is analysed by occupation. Overall, the data suggest that lower cadres in the public sector are very significantly better off than their counterparts in the private sector.

This pattern provides strong support for the claim that public sector workers are more inclined to be involved in private businesses at the expense of their duties. However, it does not bear out the claim that this is primarily a reflection of poor pay. On the contrary, lower cadre employees who make the most extra income are in fact better paid than their private sector counterparts. The capacity to make extra income would seem to be more of a reflection of opportunity, which more likely reflects lax supervision, over establishment and lower risk of sanction for absenteeism and non-performance of their duties.

Table 4.6: Non-wage income of public and private sector employees (Kshs p.m.)

	Extra income (Kshs)		As % of wage income		Extra income of pub. employees as % of private earnings	
Education	**Public**	**Private**	**Public**	**Private**	**Wage**	**Total**
None	4,104	1,522	96.1	31.0	+26.1	+70.6
Primary	2,349	895	37.5	15.8	+31.8	+52.5
Secondary	2,541	1,607	26.6	14.9	+3.8	+11.9
Undergraduate	2,905	887	13.8	3.0	-26.6	-18.9
Postgraduate	3,903	4,569	12.4	7.0	-48.0	-45.6
Occupation						
Admin. & managers	3,443	3,817	23.5	19.0	-26.8	-24.0
Professionals	4,267	3,497	17.6	11.1	-23.2	-18.7
Technicians	3,232	2,032	29.9	13.6	-27.4	-17.0
Clerks	2,074	1,355	25.0	13.6	-16.5	-8.1
Service workers	1,010	1,278	19.0	23.5	-2.7	-6.1
Skilled Agric. workers	3,187	870	40.8	12.2	+9.6	+39.0
Craft workers	2,572	1,184	23.5	16.1	+49.0	+60.0
Machine assemblers	1,987	1,180	28.2	14.9	-10.8	-0.5
Elementary occupations	1,026	754	20.5	20.5	+36.1	+36.1
All	2,662	1,331	26.6	14.0	+22.4	+33.3

Source: Labour Force Survey, 1998/99

4.7 AFFORDABILITY: FISCAL DIMENSIONS OF PUBLIC SECTOR PAY REFORM

Since the early 1990s, there has been a sustained effort to restructure and reduce the size of the public sector, aimed at achieving sustainable public finances and improved service delivery. These include the Parastatal Reform Programme, which has seen the privatisation and restructuring of various state enterprises, the Civil Service Reform Programme and the Local Government Reform Programme. In terms of wage cost containment, with regard to wage cost in particular, the Civil Service has borne the brunt of the adjustment, by means of both staff reduction and wage restraint. While employment in the public sector has contracted by 56,000 since 1992, this reflects a reduction of the Civil Service by 79,000 and an increase of 23,000 in the rest of the public sector.

Table 4.7: Impact of staffing and wage changes on the wage bill

Period	1992-97	1997-2003	1992-2003
Impact of staffing changes (Kshs billion, end of period)			
Central Government	-5.2	-3.6	-8.8
TSC	1.7	-1.3	0.4
Parastatals	-0.5	-6.0	-6.5
Majority owned companies	0.0	-3.1	-3.1
Local Government	2.4	3.1	5.5
Total	-1.4	-10.2	-11.6
Impact of pay adjustment (Kshs billion, end of period)			
Central Government	10.8	10.2	21.0
TSC	10.1	29.1	39.2
Parastatals	6.4	27.3	33.7
Majority owned companies	4.5	17.2	21.7
Local Government	5.3	15.6	20.9
Total	36.5	99.2	135.7
Net effect of staffing and pay adjustments			
Central Government	5.6	6.7	12.3
TSC	11.8	27.8	39.6
Parastatals	5.9	21.3	27.2
Majority owned companies	4.4	14.1	18.5
Local Government	7.7	18.6	26.3
Total	35.1	89.0	124.1
Change in staffing levels (employees)			
Central Government	-54 600	-24 100	-78 700
TSC	22 100	-6 500	15 600
Parastatals	-4 500	-15 500	-20 000
Majority owned companies	- 300	-6 100	-6 400
Local Government	22 800	10 700	33 500
Total	-14 500	-41 500	-56 000
Average wage (Kshs per month, end of period)			
Central Government	4,105	4,361	8,466
TSC	3,496	10,311	13,807
Parastatals	4,724	23,401	28,125
Majority owned companies	7,116	30,925	38,041
Local Government	5,923	15,157	21,080
Total	4,341	12,537	16,878

Table 4.7 provides a decomposition of the effect of changes in employment and wages on the consolidated public wage bill. From the Table, it is evident that the fiscal impact of the Civil Service reform effort has been more than offset by the combination of increased employment and wage escalation in the rest of the public sector. The staff reduction effected in the public sector since 1992 translates to annual savings of Kshs 13.5 billion in 2003. The Civil Service contributed Kshs 11.6 billion and parastatals contributed Kshs 11 billion, but the combined impact of increased employment in the teaching and local government service translates to an additional outlay of Kshs 12.8 billion. However, the savings are dwarfed by the impact of increases in the average wage, at Kshs 133.5 billion.

These figures are only illustrative, since it would not have been possible, or even desirable, to freeze nominal pay. A more realistic scenario is presented in Table 4.8. This looks at three alternative scenarios that could have been

pursued. The first assumes that the wage restraint effected on the Civil Service since 1997 had been implemented in the entire public sector. The second assumes that the Civil Service staff reduction of 79,000 had targeted the entire public sector in equal proportion to the initial levels (i.e. leaving the proportions unchanged). The third combines the two; it allows for an increase in the real average wage by 50 per cent over 1997, and staff reduction is reduced to half (i.e. 39,000) of the actual Civil Service reduction since 1992.

Table 4.8: Impact of consolidated public sector wage bill control (retrospective)

Potential savings on 2003 wage cost, Kshs billion			
	Staff reduction	**Wage restraint**	**Combination**
Central Government	-1.0	+0.4	-13.2
TSC	-1.3	-21.2	-7.4
Parastatals	-1.4	-20.9	-4.8
Majority owned companies	-0.9	-13.5	-2.8
Local Government	-0.5	-13.5	-2.4
Total	**-5.2**	**-68.8**	**-30.3**

As can be seen from the Table, all the three strategies would have achieved very different outcomes, all superior to the actual in fiscal terms. The retrenchment only scenario translates to savings of Kshs 5.2 billion. The wage restraint scenario would have been by far the most effective, with a saving of Kshs 68.8 billion on the consolidated public sector wage bill. The 50-50 scenario would have translated to a saving of Kshs 30.3 billion.

This analysis makes, in the study's view, a persuasive case for broadening the purview of the wage bill containment effort to the consolidated public sector. In this regard, the study's analysis leads to a different conclusion from the Wage Bill Management and Civil Service Performance Enhancement study. Specifically, the study concludes that:

> "With the wage bill targeted to become a smaller proportion of GDP in a stagnant or slow growing economy, *the only likely scope for salary/compensation enhancement will come from a reduction in the size of the Civil Service* (emphasis by authors)" (Valentine & Wheeler Report, pg. 44).

It is our opinion that not only is the scope for generating savings on the Civil Service wage bill through retrenchment limited, it is undesirable. Effort to do so runs considerable risk of being counterproductive. This is not to say that there is no scope for staff reduction in the Civil Service, but rather, that the staff reduction should be informed by efficiency considerations, as opposed to wage bill containment.

Chapter Five

POLICY IMPLICATIONS, OPTIONS AND PROPOSALS

5.1 POLICY IMPLICATIONS

The public sector pay crisis is first and foremost a labour market problem. The public sector cannot afford to play catch up with runaway wage growth in the economy. Ways must be found to restrain wages in the economy as a whole, where real wages are rising faster than productivity. This means that Kenya is rapidly becoming a high wage cost economy. This has four very adverse socio-economic consequences:

(i) the rising labour cost is passed on to consumers, both domestic and foreign, which undermines the competitiveness of Kenyan goods in both domestic and external markets, and/or absorbed by profits, which undermines investment, and FDI in particular.

(ii) The high wage cost economy has adverse consequences for employment and equity. A high wage cost economy compels firms to choose capital intensive industries and technologies, therefore undermining job creation. Because capital intensive production is also skill intensive, this translates into a skill premium in the labour market. In effect, rising wage, unemployment and inequality become mutually reinforcing.

(iii) A high wage cost economy will undermine public service delivery. If the wage bill continues to grow faster than revenue, it will further crowd out operations and maintenance (O&M), which are already inadequate. This means that the Government is unable to provide the public goods that the private sector needs to be competitive, and to finance the investments in people necessary to reduce poverty and inequality and to sustain growth. The alternative is to borrow, which is to compound the problem since debt service will have the same effect (i.e. crowding out O&M, as well as crowding out the private sector from the credit market).

(iv) Wage inequality in its various dimensions, in particular between the modern sector (both public and private), and the informal and agricultural sector, and between executives and lower cadres in the public sector, is a breeding ground for social grievance that could easily ignite political strife. Glimpses of this can already be felt in the public outrage that met the award of higher pay to Members of Parliament, and the Government's purchase of luxury cars for Ministers and other high ranking officials in the Government. In view of the fact that real wages have grown significantly, the persistence of pay grievances and industrial unrest can only be attributed to wage

inequalities. More generally, research evidence from across the globe shows that relative deprivation (i.e. inequality) is more closely associated with crime and social disharmony than absolute deprivation (i.e. poverty).

5.2 POLICY OPTIONS AND PROPOSALS

Restraining wages in the economy

A macroeconomic policy target for wage growth should be established as soon as possible. The policy ambivalence towards the wage rate that has obtained over the last decade represents a critical delinquency in macroeconomic policy. The deregulation of the labour market envisaged a shift from cost of living to productivity/performance based wage determination. This has not been operationalised to date. A tripartite National Productivity Centre to advise on productivity measurement and improvement was mooted. The Centre has recently been established, but it is not fully operational and is yet to embark on productivity measurement.

To this end, the void left by the inadequate Wage Guidelines should be addressed as a matter of urgency. It is the opinion of this study that in the first instance, this should be implemented by way of pronouncement and implementation of revised Wage Guidelines. Legally, the Guidelines issued in 1994 are still in force. The Guidelines set three criteria as follows:

(a) Full cost of living (i.e. 100%) compensation of the Revised Lower Income Group Nairobi CPI for low wage earners, and partial adjustment for higher wage earners.

(b) Firm productivity levels achieved during the period under review. Reference to increased labour productivity in other occupations and sectors was explicitly disallowed.

(c) Reference to the earnings of un-unionised labour identified as "lower income non-wage earners, the low non-unionised wage earners as well as the average small farmer in the rural areas."

In practice, the Guidelines are applied selectively. There is little evidence that earnings of un-unionised labour have informed the awards of the Industrial Court. Confusion abounds as to how productivity should be measured. In some cases profitability has been used as evidence of productivity improvements.

Two changes will be necessary to these criteria as follows:

(a) Productivity should be adopted as the primary criteria. That said, the reference to firm-level productivity is flawed. This is because it has the effect of penalising efficient firms by way of higher wage costs than less efficient competitors. Moreover, it would undermine the welfare benefits of

competition, by curtailing firms' ability to pass on efficiency gains to consumers through lower prices. Consequently, productivity awards ought not to exceed the industry average.

(b) The Nairobi CPI criteria for cost of living adjustments should be replaced with reference to the minimum wage. In turn, the minimum wage should be established with reference to some measure of a living wage and earnings in the informal sector.

This study is cognisant of the perception that wage guidelines are reverting to controls. However, it is to be observed that the last wage guidelines are still in force (issued under section 14 (10) of the Trade Disputes Act, Cap 229, Laws of Kenya.

Public sector wage structure

As noted earlier, there are two dimensions to the public sector pay problem. The first problem is that of the wage gap between the Civil Service and other workers in both public and private formal employment. The second is the inordinate differentials within the public sector, including the Civil Service, and in particular between the executive cadre and the other employees. The rationalisation proposals of this study are premised on, and informed by, two principles. The first principle relates to public service ethic and values. Simply put, this is to say that money should not be the primary motivation and reward for a career in the public service. The second is fairness. This dictates equal pay for equal work.

In order to apply these principles, functional distinction should be made between the public sector and public service, and within public service, between core and non-core functions. This taxonomy translates into the following characterisation of the public sector:

"Primary" government

These are the institutions that perform the core governance functions and service delivery functions. They include:

- The Civil Service (including Judiciary)
- The military
- Local authorities
- Regulatory parastatals (e.g. Central Bank) and the utilities regulators (e.g. ERB, CCK, CMA, RBA, etc)

"Secondary" public services

These are entities that provide public and social goods, and would typically be not-for-profit organisations even if they were private. They include

education and research, health services, and institutions such as regional development authorities (TARDA, KVDA, etc).

Public enterprises

These are commercial state corporations. For purposes of wage policy, these need to be further broken down into two categories namely:

(a) Statutory monopolies (e.g. KPLC, KPA, Kenya Railways, Posta Corporation, water service companies, etc).

(b) Market competing enterprises (e.g. banks).

The essence of this distinction is that the former can extract monopoly rents from consumers to finance higher wages, while the latter are constrained by market competition.

This functional classification of the public sector shows clearly that the current public sector pay determination cannot be justified on the basis of function. In particular functions of parastatals range from core governance functions (such as KRA), to commercial enterprises that are not public services of any description. Based on this characterisation, the study makes the following recommendations:

- *"Primary" and "secondary" government*: These should be brought under unified terms and conditions of service based on the Civil Service job classification. This will attenuate institutional inflation, i.e. proliferation of parastatals whose primary motivation would appear to be pay and patronage. In other words, public servants should be indifferent between the public services in terms of compensation, career prospects and stature.

- *Statutory monopolies:* These should be left to set their pay with reference to the market, within the parameters established by their regulators, and subject to performance contract with the Government. Wage cost targets should be one of the key elements of the performance contracts.

- *Market competing enterprises:* These should be treated as private sector entities, and left free to set their pay with reference to the market.

Executive pay policy

This is a question of leading by example. Executive compensation in the public service is not just a wage policy issue. It is central to the question of public service ethics and values. At the heart of the matter is a culture of privilege and opulence that has over the years taken root in the political class and the upper echelons of the public sector.

This study recommends that a public service executive pay policy be formulated. It should encompass all executive appointments (i.e. Permanent Secretaries, Judges, chairpersons, members and chief executives of the various

statutory Commissions such as the Electoral Commission, Human Rights Commission, Anti-Corruption Authority, etc) and allowances of boards of directors of state corporations. The policy should articulate rational criteria that will be used to review the levels and structure of executive compensation. The options are:

- *Market.* Three options can be considered. These are (a) job comparison, (b) the transfer earnings (opportunity cost) of a typical public service executive, and (c) competitive pay. Job comparison would entail assessing what the market pays for comparable levels of responsibility. It portends a problem of suitable comparators, since jobs like Permanent Secretaries, Judges or the Commissioner of Police have no close comparators outside Government. Transfer earnings criteria would entail, for example, the earnings of a typical judge in private practice. For others, it is possible to look at their potential earnings in alternative public administration careers such as development NGOs and inter-governmental organisations. The competitive pay approach would entail making the executive jobs contestable. This would entail inviting applications for the jobs and setting the pay based on what candidates with the appropriate qualifications are willing to accept.

- *Status.* Status wage criteria would entail determination of the cost of living commensurate with the status the public service executives should have in society. This would entail construction of a basket of goods (housing, medical insurance, education) for a reference tier of executives (e.g. Permanent Secretaries).

- *Equity.* The equity criteria would entail some predetermined notion of equity within the public service. This would entail indexing executive compensation to a reference wage (e.g. lowest scale), average earnings or other reference group (e.g. entry level pay for professionals) in the public service.

Of the three options, the opinion of this study is that the equity criteria should be the primary consideration, it being the most consistent with the public service ethos. Upon adoption, salaries that are higher than stipulated should be made personal to the individual incumbents. Given that anomalies will remain, the following options should be considered.

- Early retirement with full benefits and a "golden handshake";

- Immediate retirement with full benefits, and re-employment on fixed term contracts under the new terms.

Institutional reforms

Conflict of interest constitutes the most fundamental problem of public pay determination. Simply put, a person cannot sit in judgement over his or her own case, but this is generally the practice for senior cadres in the public service. Consequently, the most critical reforms are institutional. Considering

that well over two-thirds of public sector employees are unionised, the Government has paid remarkably little attention to collective bargaining agreements. Conflict of interest is pervasive. In Local Government, all employees, including the chief executives (town clerks) are unionised. The same applies to university administrators. As lecturers, they are beneficiaries of the CBAs that they negotiate.

In the private sector, collective bargaining arrangements, where management negotiates with the unions, is based on the principle that interests of management are aligned with the interests of shareholders. The amount that the company can pay workers is constrained by profitability (i.e. management and shareholders have an interest in the viability of the business). This is not the case in the public sector. Even though they are not unionised, the interests of management cadres in the public sector are aligned with those of unionised employees. This is because an increase in the pay of unionised workers necessary provides a justification for increasing management pay. Unlike the private sector, public sector managers can expect to pass on the costs to taxpayers. It follows then, that public sector managers cannot represent the best interests of the public in wage negotiations.

The study, therefore, recommends that the Government reviews all collective bargaining arrangements in the public sector with a view to ensuring that no interested parties negotiate pay on its behalf. In this regard, it is also imperative that the collective bargaining process be insulated from the political process in order to attenuate the temptation of political parties promising pay awards to entice voters.

These imperatives make, in the view of this study, a strong case for an independent, politically insulated public pay determination process. This is indeed the spirit in which the Public Service Commission is enshrined in the Constitution. To this end, and in view of the acknowledged failures of the *ad hoc* existing processes, in particular the presidential commission system, consideration should be given to:

(a) Transfer of the pay determination function of the entire public service to the Public Service Commission. This does not preclude the Commission delegating this function to other bodies, such as the Teachers, local Government and Parliamentary Service Commissions.

(b) Following on (a) the Public Service Commission be mandated to negotiate a Public Service Industrial Relations Charter with all the public sector unions.

(c) Establishment of a fully-fledged Ministry of Public Service, independent from the Office of the President, with performance improvement as its primary responsibility.

5.3 FINANCING PUBLIC PAY REFORM

The public pay reform envisaged portends a fiscal dilemma. The following principles can be drawn from the study:

- Adequate compensation of the Civil Service must go hand in hand with adequate O&M outlays. Resources spent on one at the expense of the other will not translate into improved service delivery.
- These must be financed in a fiscally responsible and investment friendly manner. Onerous taxation, inflationary deficits or excessive borrowing (both domestic and foreign), will sooner or later undermine both job creation and poverty reduction, the very objectives that the public expenditure is intended to support.

In short, there are no viable trade-offs between wages and O&M, and revenues and expenditures. This leaves three options, namely (a) grant aid (b) re-allocating resources from development to recurrent budget, and (c) rationalisation of public facilities. Each of these option is considered in turn.

Grant aid

Seeking more grant aid is arguably the least costly way of financing the pay reform. This will require the Government to persuade the donors to provide more funds in the form of budget support. In practice, however, donors have not been very keen on financing recurrent budget with long-term implications. There are at least three risks to consider. First, the Government needs to have a reasonably high degree of confidence that the pay-off in terms of economic growth will generate the revenues to absorb the increased outlays in the near future. Second, for various reasons, which include fluctuations of aid budgets and conditionalities, grants are highly volatile, both in terms of annual flows as well as the timing of disbursements. Therefore, heavy dependence on grants will make the budget highly vulnerable to this volatility, with the effect that if grants fail to materialise, the Government will be compelled to cut expenditures or resort to unplanned domestic borrowing. Third, as it is, the Government's service delivery commitments on primary education and other poverty reduction interventions are already heavily aid-dependent. Increased aid dependency will invariably impinge on policy autonomy.

Reallocations from development to recurrent budget

In the view of this study, this is desirable. The case for initiating new development projects when the Government is unable to adequately operate and maintain the existing ones is hard to make, other than those absolutely essential for reasons of equity (e.g. providing schools and dispensaries where none exist). It has to be recognised, however, that this is easier said than done,

for two reasons. First, the development budget is heavily dependent on external finance, both loans and grants. This in effect means that reallocations will require the cooperation of donors, whose traditional inclination is to finance new projects. Second, this will require considerable change of the deeply ingrained political culture that puts a premium on the "development" budget (i.e. new facilities rather than securing adequate recurrent outlays for existing ones).

Rationalisation of public facilities

By this is meant reducing, by various means, the government's existing physical facilities. It is arguably a drastic and radical measure, but it is one that we believe merits serious consideration. As observed earlier, although O&M outlays per employee registered significant increases in the 1990s, as a ratio of the capital stock (i.e. physical facilities), the outlays fell precipitously, reaching a historic low by the end of the decade. Simply put, the Government has accumulated more capital than it can operate and maintain effectively. This reflects the tendencies referred to above, namely, the affection of donors, politicians and indeed citizens, for "development" projects. Reducing the number of facilities that the Government operates would enable it to allocate sufficient recurrent outlays, both staff and overheads, to deliver a level of service from these facilities that is greater than is achieved by spreading resources thinly over a larger portfolio.

By way of example, the Government owns and operates a large portfolio of "village polytechnics". Over time, these vital institutions have deteriorated to the point where many of them are underutilised. Salaries are so low that instructors seldom turn up for work, buildings and equipment are in disrepair, and operating budget is hardly sufficient to purchase the necessary instructional materials. Yet, with proper management, these facilities have the potential to be self-financing, given that there are many training institutions that provide the same services for profit. This seems to be strong case for rationalisation (i.e. reducing the number of institutions to those that the Government can afford to operate). The remaining institutions may be given to the beneficiary communities, leased to private entrepreneurs or NGOs willing to operate them, or converted to other uses such as secondary schools.

Finally, there is considerable anecdotal evidence suggesting significant scope for efficiency gains, on both wage and O&M outlays. Relentless pursuit of value for public money is not an option. It is an imperative. Adequate and fair compensation are necessary, but not sufficient to ensure diligent and honest public servants. Incentives for good performance need to be enhanced, and sanctions for malfeasance escalated and applied rigorously. To this end, a rigorous performance evaluation system is a matter of urgency.

Chapter Six

CONCLUSIONS

Kenya is rapidly becoming a high wage cost economy. This is an urgent policy challenge as it threatens external competitiveness, macroeconomic stability and fiscal sustainability, which are the necessary conditions for poverty reduction, job creation and growth. The study highlights two significant positive responses of the economy to deregulation, namely, export growth as well as diversification, and job creation, including reviving job creation in the agricultural sector. This trend reversed in the latter half of the 1990s. The evidence points to the escalation of wages as the probable cause.

This study draws two significant inferences from this analysis. First, external competitiveness is the critical link between growth and employment. Put differently, the sources of growth matters. Job creation by domestic absorption, by means of direct public employment, fiscal stimulus or protection and/or subsidies, is both inequitable and unsustainable. Second, to the extent that labour absorption in agriculture is pro-poor, this analysis provides strong evidence that macroeconomic competitiveness is critical for both job creation and poverty reduction.

The study avers that the wage problem in all its dimensions is a consequence of the failure to institutionalise liberalisation. Building institutions to govern liberalised markets must become one of the Government's foremost good governance agenda. In the economics discourse, it is now universally acknowledged that factor markets (labour and capital), suffer from more severe information asymmetry than product markets; that is, employers and lenders lack adequate information about the attributes of workers and borrowers respectively. This gives rise to pervasive market failure (i.e. prices — wages and interest) not to adjust, as they should, to equate the demand and supply, the result of which is persistence of voluntary unemployment and credit rationing.

Viewed from this perspective, the observed impact of deregulation on the labour market — rising wages alongside high unemployment — and inordinately large spreads between deposit and lending rates in the aftermath of deregulation of interest rates, are both consequences of the failure to adapt policies and build institutions for governing markets. A deregulated banking sector requires a statutory consumer protection function, assigned to either the monetary authority, financial sector regulator or competition authority. Had this been envisaged and implemented when interest rates were deregulated, the "Donde Bill" saga would not have occurred. In the case of wage deregulation, some institutional reform was envisaged but not implemented. Quite evidently, wages have been outstripping productivity

for well over a decade. It does not seem to have become a concern to the relevant authorities, perhaps suggesting that policy makers have not appreciated the adverse socioeconomic consequences of a high wage economy highlighted in this study.

With regard to public sector, the labour market problem is compounded by pervasive conflict of interest in the wage determination institutions and processes. There are three dimensions to this problem. The first is that of public officers being judges in their own case, the most glaring one being that of Members of Parliament. The second is the wide latitude of discretion that senior cadre of the Civil Service has to adopt and implement recommendations made by pay review commissions selectively. The third, which applies mostly to state corporations, is that the interests of the managers who negotiate CBAs are aligned with those of their co-workers as opposed to the public interest since increases in the compensation of unionised workers necessarily justifies upward adjustment of their own.

This institutional failure underlies the glaring distortions in the public sector pay structure, in particular, the wide gap that has opened between state corporations and the rest of the public sector, and the inflated salaries of senior cadres relative to domestic market and international public service pay norms. The latter (i.e. the executive wage) premium is in part responsible for the institutional inflation that has been characteristic of the public sector since independence, on account of the vested interest of the national elite to create more jobs for themselves. It is, in the view of this study, perhaps the most fundamental public sector reform issue that the Government needs to confront.

The issues raised in the study constitute a formidable challenge, requiring bold policy and institutional reforms and capacity building. The study amply demonstrates that over the last decade, macroeconomic policy in Kenya has not paid sufficient attention to the labour market. This oversight needs to be addressed as a matter of urgency. In addition to the adverse growth and employment consequences that have been highlighted, failure to do so portends the risk of a wage inflation spiral (i.e. rising wages fuelling inflation, precipitating further wage demands, which fuel more inflation). This genre of inflation is much more difficult to manage than the traditional sources of inflation in Kenya, namely, fiscal deficits and exchange rate depreciation.

Although the study makes some specific proposals, its purpose is to propose an evidence-based policy framework (i.e. principles and criteria that are consistent with socio-economic goals and fiscal sustainability).

There are several areas of further study that are suggested. A better understanding of labour market dynamics is required. Equally important are studies on labour productivity, in the public sector in particular, and on economic and social returns of public expenditures.

Finally, addressing the issues raised in the study is not the responsibility of the Government alone. Collective action, enjoining employers, the labour movement and development partners. Trade union leaders in particular need to be persuaded that wage settlements that have adverse consequences on the economy are not in the best interests of workers. Development partners also need to be more cognisant of the unintended adverse consequences of their preferences. They have contributed to the pay and expenditure distortions in various ways, notably by financing inflated executive salaries, and by dint of their historical bias for capital over operations and maintenance outlays. Above all, the Government must lead by example. As long as the culture of privilege that has taken root in the senior cadres of the public service obtains, the Government will lack the moral authority to demand sacrifice of others.

APPENDIX 1: ESTIMATING THE IMPACT OF PUBLIC SECTOR WAGES ON GROWTH

This analysis investigates the effect of public sector wages on economic growth. The central proposition to be modelled is that growth is dependent on competitive production. In turn, competitive production comes from efficient private sector activity supported by public goods. If the public sector fails to deliver the necessary public and merit goods (e.g. security, stable and secure power, uninterrupted communications–be they phones, rail or roads), then the private sector has to incur extra costs, therefore losing its competitive edge. A worse picture emerges if the public sector actually frustrates the private sector by corrupt practices or by crowding out in the factor markets.

The public sector has inherited a stock of capital: buildings, vehicles, equipment, installations, etc. That capital requires some level of maintenance in order to prolong its productive life. Furthermore, efficient use of these facilities requires appropriate levels of staffing–both with respect to numbers and qualifications–and the necessary operational inputs such as fuel for motor vehicles, textbooks in schools, medicine in the health facilities, etc.

As a whole, the public sector has an envelope of financial resources that come from taxes and levies, sale of services, external grants and loans and domestic borrowing. These resources are spent paying labour, servicing debt (including pension liabilities), increasing the capital stock, and a mixture of operating and maintenance expenditures. Within the public sector there are a number of transfers that cancel out in aggregate but affect the efficiency of resource use.

Although the number of workers in the public sector is known, theory says, and is supported in reality, that the wage contract is one in which asymmetric information allows workers to withhold effort (often resorting to absenteeism) making the actual effective workforce a fraction of the nominal roll. There are also "ghost" workers on the pay roll. Managers/supervisors and other forms of obtaining information on work effort can easily outweigh the potential benefit of a tighter more disciplined workplace.

In order to induce workers to be more efficient–to increase their productivity – a wage premium may be offered. The premium is not just related to the value of the potential output, but also to the labour market situation. Readily available, higher paying jobs force an upward salary revision. In Kenya, there is considerable unemployment, but if one can get an executive-level job in the formal sector it tends to pay better than the Civil Service. On the other hand, discipline is usually tighter in the private sector and workers are normally prepared to stay over time because of the risk of losing the job if they do not. The other public sector executive jobs are often given as part of patronage; monitoring of productivity is not the norm.

Given that the private sector and the other public sector are the alternatives faced by the civil servant, their salary scales can be expected to affect the level of effort that a bureaucrat in the Civil Service will put out for a lesser income. The level of effort demanded in return for an equivalent salary is greater in the private sector, hence one would expect the wage in the other public sector to be the appropriate comparator.

Furthermore, it is unlikely that the relationship is linear with respect to its effect on effort. The ratio could rise as a consequence of a rise in Civil Service wages (the numerator) or a fall in other public sector wages (the denominator). Taking the former first, as the Civil Service wage approaches parity, there is less incentive to opt out since the job looks better in comparison, but there comes a point where the cost of paying higher wages is by reducing O&M and hence frustrating the workers no matter how enthusiastic.

The ideal data for testing this proposition are not available. One would want to be able to separate operating costs from maintenance expenditures; this is not possible. One would want to separate capital stock into that used by, for example, Central Government, Teacher Service Commission (TSC), commercial activities where the Government has majority ownership (e.g. sugar companies) or regulatory parastatal bodies; again this is not possible. In fact, there is even a difficulty in identifying the capital stock which should be transferred to the private sector as a result of divestiture of an erstwhile parastatal (e.g. Kenya Airways).

A very large proportion of transfers go to TSC which are almost entirely wages. Although the Local Authority Transfer Fund is supposed to pay for district level development, it appears to have been utilised for salaries. Hence, Central Government transfers, which are made at the cost of O&M and salaries, may well be counter-productive.

There is reason to believe that civil servants are dissatisfied with their pay not just because of its absolute level, but also because of its level relative to private and other public comparators.

To test this model, a regression equation was estimated with the following data/variables:

- Gr = annual growth rate of GDP at factor cost (1982 values)
- Kb = public sector capital stock computed by the perpetual inventory method, with conventional rates of depreciation (1982 values)
- OM = nominal value of Central Government's annual (financial year) expenditures on operations and maintenance
- Lg = Central Government's labour force
- Wg = the average payment per annum to a Central Government worker

- Wob = the average payment per annum to all other public sector workers
- Wv = the average payment per annum to non-agricultural workers in the private sector
- Pg = the Government services deflator from the national accounts (1982 = 100) for deflating OM

As has been argued above, it is unlikely that the effect of relative wages is linear. Higher Wg may encourage extra effort, but if it comes at the cost of OM there is a dampening effect. If Wv rises, it could be inflationary, or it could represent an increase in productivity. A rise in Wob may attract more competent staff to parastatals, but it will also disillusion civil servants who remain in the service.

The econometric results are provided in Table A1.1. Only the statistically significant coefficients are provided in the Table. It will be noted that:

(a) contemporary values of variables are only significant for Wg/Wob in all three equations and (OM/Pg)/Kb in two

(b) only four lagged variables were significant in all equations

(c) only one non-relative wage variable, (OM/Pg)/Kb, was significant in all four equations

(d) the dominance of the relative wage variable, Wg/Wob, in both the linear and squared terms suggests that there is a critical value which will yield the maximum growth (the sign on the terms ensures that it is a maximum)

(e) the sign of the (OM/Pg)/Kb variable indicates that either increasing real operating and maintenance expenditures or downsizing the public sector asset portfolio would raise growth

Table A1.1: Regression estimates of public wage effects on growth

Lags		Eq 1	Eq 2	Eq 3
	Const	-31.3793	-5.1753	-8.7203
0	Wg/Wob	61.8035		3.7800
1	Wg/Wob			
2	Wg/Wob	109.7867	79.1088	91.7699
3	Wg/Wob			
4	Wg/Wob	-28.6712	-72.2342	-59.9283
0	Wg/Wob2	-30.4963		
1	Wg/Wob2			
2	Wg/Wob2	-53.6822	-38.9393	-48.9246
3	Wg/Wob2	-6.0163	-4.5418	
4	Wg/Wob2		28.1561	27.4610
0	Wg/Wv	-74.0218		
1	Wg/Wv	-13.1137		
2	Wg/Wv			
3	Wg/Wv			
4	Wg/Wv	22.8008	16.8341	
0	Wg/Wv2	44.2478		
1	Wg/Wv2			
2	Wg/Wv2			
3	Wg/Wv2			
4	Wg/Wv2			
0	(OM/Pg)/Lg	-0.0008		
1	(OM/Pg)/Lg	0.0004		
2	(OM/Pg)/Lg			
3	(OM/Pg)/Lg			-0.0002
4	(OM/Pg)/Lg			
0	(OM/Pg)*Lg	0.0078		
1	(OM/Pg)*Lg	-0.0086		
2	(OM/Pg)*Lg	0.0099		
3	(OM/Pg)*Lg		0.0027	
4	(OM/Pg)*Lg			0.0019
0	(OM/Pg)/Kb	0.2160	0.0451	
1	(OM/Pg)/Kb			
2	(OM/Pg)/Kb	-0.1325		
3	(OM/Pg)/Kb		-0.0565	
4	(OM/Pg)/Kb	0.0255	0.0356	0.0110
	Rsq	0.9494	0.8465	0.7608
	Rbarsq	0.8926	0.7825	0.6872
	Std error	0.7037	1.0012	1.2007

All coefficients are significant at the 1% level

It is possible, using equations 3 (since it has no contemporary values of variables), to forecast the range of likely growth in 2004 at 2.8 per cent. Assuming a reasonable real O&M per Kshs 1,000 of real public capital stock for 2004, equation 2 gives approximately the same result. Unfortunately, the standard errors of these equations are large.

APPENDIX 2: ECONOMETRIC ANALYSIS OF WAGE DETERMINATION IN THE PUBLIC AND PRIVATE SECTOR

This appendix presents estimates of the potential earnings of public sector employees in the private sector and vice versa. The analysis proceeds in two steps as follows: First, is the estimate of the effects of workers attributes (education, training, age, etc) on earnings in the private and public sector separately. The parameters obtained from the private sector model are applied to the attributes of the public sector workers, and vice versa. The results provide an estimate of the transfer earnings (i.e. what a worker with the average profile of a public sector worker can expect to earn in the private sector, and vice versa).

ECONOMETRIC RESULTS

Separate semi-logarithmic earnings equations for public and private sector employees are estimated using data from the LFS 1998/99. The dependent variable is the natural logarithm of monthly earnings. The equations have been estimated using ordinary least squares (OLS).

Table A2.1: Public and private sector earnings regression results

Variables	Public sector coefficients	Private sector coefficients
Constant	7.740*(31.71)	7.048* (27.94)
Age	0.057* (4.99)	0.071* (8.21)
Age squared	-0.001*(-3.92)	-0.001*(-5.87)
Training dummy	0.171* (5.35)	0.291* (6.01)
Rural dummy	-0.189*(-6.27)	-0.215*(-5.34)
Primary dummy	-0.093(-0.83)	0.276* (3.88)
Secondary dummy	0.252* (2.24)	0.625* (8.19)
Undergraduate dummy	0.887* (6.93)	1.395* (8.67)
Postgraduate dummy	1.023* (7.26)	1.475* (9.89)
Regional controls	Yes	Yes
Occupation controls	Yes	Yes
Number of observations	1272	1237
Adjusted R-squared	0.446	0.527

As indicated by the R^2, the earnings regression in the equation for private sector workers in the sample is better explained by the independent variables in comparison to the equation for public sector employees. In both sectors, experience, proxied by age, is important as a determinant of wage levels, marginally more so in the private sector. The premium attached to training (skill improvement) is higher in private than in public sector as expected and those employees stationed in the rural areas receive lower earnings than those in urban areas.

The education premium is higher in the private than the public sector, and very significantly so. Therefore, although the public sector is one of the largest employer of university graduates, many see it as a place to acquire some experience to enable them future access to better paying jobs in the private sector. Highly skilled individuals are therefore attracted to the private sector, which may partly explain the Government's inability to fill management level positions in the public sector.

Tables A2.2 and A2.3 show the estimated earnings coefficients based on rural and urban sample respectively. The results are similar to those at the national level except that now the explanatory power of the regression for the rural areas is much lower, while that for urban areas is higher than for the national level. Also, in the public sector there is no significant difference in the earnings for those with no education, primary education and secondary education. This is partly explained by more rigorous adherence to minimum wages in the public sector. This probably explains why those holding low-level jobs in the public sector tend to remain there up to retirement.

Another reason for remaining in public sector employment for these groups is the higher level of security attached to public employment. Moreover, since low-level jobs in the public sector are loosely supervised, they provide greater opportunities for shirking and even outright corruption than private employment. Although not shown in the tables, results indicate that regional effects on earnings are important for employees in both private and public sectors, but are more marked in the private sector. In the private sector, remoteness is a key factor in wage determination. The fact that location effects on wages are generally less pronounced in Government than in private employment is in part a reflection of the relative homogeneity of the civil service labour market.

Table A2.3: Earnings regression results for public and private sectors, rural areas

Variables	Public sector coefficients	Private sector coefficients
Constant	7.645* (25.35)	7.478* (27.94)
Age	0.053* (3.77)	0.037* (3.29)
Age squared	-0.001*(-3.04)	-0.0003*(-1,79)
Training dummy	0.174* (4.07)	0.356* (5.20)
Primary dummy	-0.131(-1.02)	0.167* (2.18)
Secondary dummy	0.163 (1.26)	0.492* (5.65)
Undergraduate dummy	0.784* (5.05)	1.133* (3.74)
Postgraduate dummy	0.822* (4.45)	1.097* (4.78)
Regional controls	Yes	Yes
Occupation controls	Yes	Yes
Number of observations	776	661
Adjusted R-squared	0.424	0.370

Table A2.4: Earnings regression results for public and private sector, urban areas

Variables	Public sector coefficients	Private sector coefficients
Constant	7.698* (17.08)	6.911* (21.81)
Age	0.067* (3.27)	0.096* (7.27)
Age2	-0.001*(-2.47)	-0.001*(-5.55)
Training dummy	0.182* (3.81)	0.239* (3.56)
Primary dummy	-0.040(-0.17)	0.595* (3.85)
Secondary dummy	0.389 (1.68)	0.927* (5.96)
Undergraduate dummy	1.043* (4.21)	1.602* (6.95)
Postgraduate dummy	1.245* (4.83)	1.719* (7.48)
Regional controls	Yes	Yes
Occupation controls	Yes	Yes
Number of observations	496	576
Adjusted R-squared	0.473	0.581

ANNEX 1: INSTITUTIONS AND PERSONS CONSULTED

Ministry of Finance

Hon. David Mwiraria	Minister
Joseph Magari	Permanent Secretary
Maurice Kanga	Economic Secretary
Njeru Kirira	Director, Fiscal and Monetary Affairs
Anne Njiru	Ag. Director, Budget
Jennifer Sharpley	Advisor

Ministry of Planning and National Development

Hon. P. Anyang-Nyongo	Minister
Michael Chege	Advisor
Sam Mwale	Advisor

Ministry of Labour

Hon. Chirau Ali Makwere	Minister
Deborah D. Ongewe	Permanent Secretary
Rachel B. Dzombo	Finance Officer
Samson Machuka	Principal Personnel Officer
C.N. Kaseya	Head of Planning

Cabinet Office

Francis Muthaura	Head of Civil Service & Secretary to the Cabinet

Central Bank of Kenya

Andrew Mullei	Governor
Edward Sambili	Deputy Governor
Aloys B. Ayako	Director, Research
B.O. Maturu	Economist, Research Dept
C. Kiptoo	Economist, Research Dept

Ministry of Local Government

Z. Ogongo	Permanent Secretary
S.G. Karicho	Principal Personnel Officer
A.S. Wambugi	DDLA Inspectorate
H.S. Chavera	Finance Officer
F.W. Maina (Mrs.)	Coordinator, Kenya Local Government Reform Programme

State Corporations Advisory Committee

Mr. David Namu	Chairman
Mr. J.M. Otenyo	Inspector-General of State Corporations
Mr. R.O. Wa-Mwenje	Secretary

Directorate of Personnel Management

Simon P. Njau	Permanent Secretary
Joab O. Manyala	Deputy Director, Personnel Administration
Jackline L. Yonga	Snr. Asst. Director/ Personnel Administration
Peter Odundo	Deputy Chief Finance Officer
O. Kenani	Head, Personnel
T. Ndambuki	Ag. Director, PD/CSRS

Permanent Public Sector Pay Review Board

Gaylord Avedi	Chairman
Mark Bor	Secretary

Teachers Service Commission	
J.E.O. Ongwae	Secretary
Nancy M. Macharia	ADS (PP)
Luka J.O. Spira	DS
Cheptomo Ayabai	ADS
S.M. Kathuo	PFO
M.N. Mbae (Mrs)	DSCA

Public Service Commission	
A.M.H. Sharawe	Chairman
S.S. Boit	Secretary

Central Organisation of Trade Unions	
George Odiko	Asst. Secretary General
Noah Chune	Economist
A.W. Githinji	Economist

Federation of Kenya Employers	
Walter Mukuria	Chairman
Tom Owuor	Executive Director
Gerishon Konditi	Deputy Executive Director

Kenya National Union of Teachers	
George Wesonga	First National Vice Chairman
David Okuta	Asst. Secretary General

ANNEX 2: TERMS OF REFERENCE

The purpose of the study is to review the structure and determination of public sector pay, and to recommend a public sector wage policy that will promote national economic and social goals. To this end, the consultants will:

- review the overall wage structure in the economy, and wage determination policies and practices and establish the extent to which they support equity and growth.
- study the historical evolution and determination of public sector pay, and identify the causes underlying unsustainable growth of the public wage bill.
- recommend policy and institutional reforms necessary to ensure that public sector pay is *adequate, equitable, affordable* and *supportive of economic recovery.*

Scope of the study

The study is intended to provide a policy framework for public sector pay determination. In this regard, the study's principal objective is to propose principles and rational criteria that can be applied uniformly in all remuneration reviews. The study will cover the public sector as a whole, namely, the Central Government, local authorities, teachers and parastatals.