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SERVICES AND DEVELOPMENT: IMPLICATIONS FOR THE TELECOMMUNICATIONS, BANKING AND TOURISM SERVICES SECTORS IN KENYA

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Note

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Abbreviations

ADC	Agricultural Development Corporation
AFC	Agricultural Finance Company
ATM	automated teller machine
ATM	Automated Teller Machines
BASA	Bilateral Air Service Agreement
CBA	Commercial Bank of Africa
CBK	Central Bank of Kenya
CCK	Communication Commission of Kenya
CDS	Central Depository System
CIC	Capital Issue Committee
CMA	Capital Markets Authority
CMU	Communications Management Unit
COMESA	Common Market for Eastern and Southern Africa
COMTEL	COMESA Telkom Project
CRS	Computerized Reservation Systems
CTDLT	Catering and Tourism Development Levy Trustees
DBS	Direct Broadcasting Satellite
DFCK	Development Finance Company of Kenya
DFI	development financial institution
DPF	Deposit Protection Fund
EAC	East African Community
EAP&TC	East African Posts & Telecommunication Corporation
EC	European Commission
EDI	Electronic Data Interchange
ENT	economic needs tests
EPA	Economic Partnership Agreement
ERS	Economic Recovery Strategy
ERS	Economic Recovery Strategy for Wealth and Employment Creation
ESA	Eastern and Southern Africa
GATS	General Agreement of Trade in Services
GDP	Gross Domestic Product
GDS	Global Distribution Systems
GITS	Government Information Technology Services
GMPCS	Global Mobile Personal Communication by Satellite
GSO	Ground Systems and Operations
HRA	Hotels and Restaurants Act
ICAO	International Civil Aviation Organization
ICDC	Industrial and Commercial Development Corporation
ICT	information communication technology
IDB	Industrial Development Bank
IMF	International Monetary Fund
IP	Internet protocol
ISP	Internet service provider
IT	Information Technology
ITA	Information Technology Agreement (WTO)
ITC	International Trade Center

ITU	International Telecommunication Union
JITAP	Joint Integrated Technical Assistance Programme
KACE	Kenya Agricultural Commodity Exchange
KATA	Kenya Association of Travel Agents
KATO	Kenya Association of Tour Operators
KBA	Kenya Bankers Association
KCB	Kenya Commercial Bank
KENET	Kenya Education Network Initiative
KENPAC	Kenya Packet Switched Public Data Network
KENSAT	A VSAT (Very Small Aperture Terminal) network service of Telkom Kenya
KIPPRA	Kenya Institute for Public Policy Research and Analysis
KPTC	Kenya Posts and Telecommunication Corporation
KPOSB	Kenya Post Office Savings Bank
KRA	Kenya Revenue Authority
KTB	Kenya Tourist Board
KTDC	Kenya Tourist Development Corporation
KUC	Kenya Utalii College
KWS	Kenya Wildlife Services
MFI	Micro-Finance Institutions
MFN	Most Favoured Nation
ML	Main Lines
NBFI	non-bank financial institution
NBK	National Bank of Kenya
NCS	National Communication Secretariat
NEPAD	New Partnership for African Development
NGO	Non-Government Organization
NMK	National Museums of Kenya
NPL	Non-Performing Loans
NSE	Nairobi Stock Exchange
NSSF	National Social Security Fund
PAPU	Pan African Postal Union
PC	Personal Computer
PCK	Postal Corporation of Kenya
PRSP	Poverty Reduction Strategy Paper
RASCOM	Regional African Satellite Communication
RBA	Retirement Benefits Authority
SACCO	savings and credit society
SADC	Southern African Development Community
SAFARISAT	A Global Satellite Communications Service of Telkom Kenya
SDR	Special Drawing Right
SME	small and medium-sized enterprise
STD	Subscribers Trunk Dialing
TA	Technical Assistance
TICAD	Tokyo International Conference on African Development
TILA	Tourist Industry Licensing Act
TKL	Telkom Kenya Limited
UN	United Nations
UNEP	United Nations Environmental Programme

UNCHS-Habitat	United Nations Centre for Human Settlements
UNWTO	World Tourism Organization
US	United States
USAID	United States Agency for International Development
VAT	value added tax
VoIP	Voice over Internet Protocol
VSAT	Very Small Aperture Terminal
WCMA	Wildlife Conservation and Management Act
WCMD	Wildlife Conservation and Management Department
WSIS	World Summit Information Society
WTO	World Trade Organization
WTTC	World Travel and Tourism Council

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Abstract

The study aims at contributing to the assessment of trade in services in developing countries. Based on sector-specific case studies in Kenya, the paper seeks to present a national experience on the performance of different sectors and the attainment of the policy objectives sought. As a result, a list of options and approaches could be established to demonstrate where liberalization must be complemented by policies to attain established development objectives, and what form these policies could take. Progressive liberalization of trade in services, under appropriate regulatory, institutional and policy frameworks, is expected to contribute to enhancing global welfare through increased efficiency, lower prices, greater choice and increased domestic competition. This study examines the Kenyan approach in telecommunications, tourism and banking services.

Telecommunications services are infrastructure services and the main drivers of the global tradability of goods and services, as well as the means for offshoring a wide range of information and communication technology (ICT)-enabled services and business process outsourcing. However, liberalization and privatization of this sector have to be carefully managed to prevent anti-competitive behavior, ensure universal coverage, affordable pricing and widening the access to all types of services. The following case study in Kenya shows why the gradual liberalization process in the telecom market faces difficulties in attracting private and foreign investments; it also shows how the expected immediate negative impact on employment has made reforming the sector particularly difficult, as well as how important are policies promoting small and medium-sized enterprises (SMEs), especially in creating new employment opportunities.

The lessons learned in the assessment relate to policies which need to be put in place to ensure success in telecommunications services reform, including (a) development and expansion of national and regional infrastructure, and inviting private sector investment and financial support from development partners; (b) the establishment of the Universal Service Fund to facilitate extension of telecommunications services to the rural areas, where government investments and partnerships continue to be important; (c) improvement in the business environment to facilitate new investments and to expand existing ones; and, (d) ensuring ICT human resource development, promoting e-commerce and e-Government and enabling policy and legislative frameworks.

In the case of tourism services, the study shows that, among others, domestic liberalization of the sector depends on the degree of integration of the domestic tourism sector in international tourism networks and distribution channels, global business practices, competitive conditions in foreign markets, access to distribution networks and the degree of the leakage effect. It also attests to the high degree of vulnerability to external shocks and volatility, especially of the international tourism flows. The importance of public policies in favor of SMEs are particularly emphasized in tourism. Assessment also underlines that there are significant market access and national treatment barriers in the developed country markets, mainly with respect to restrictions on movement of professionals who supply tourism services, and restrictions on some forms of tourism business, which developed countries need to ease or remove, including in the trade negotiations, by undertaking commercially meaningful commitments on Mode 4 as well as implementation of article IV in respect of assuring access to distribution networks.

Like telecommunications, financial services play an infrastructure role in driving trade and services, and are a key element of an enabling investment climate. The services underpin global economic growth and provide infrastructure for trade in goods and services. They are key drivers of development process, by linking up investors with lenders. Not only does the financial sector ensure intermediation, it also facilitates exchanges in the goods and services market. Moreover, it provides an opportunity for households and enterprises to better manage risks. A good financial system ensures efficient mobilization of domestic savings, attractive returns to investors and savers, encourages sound institutional management and competitive charges for financial services, and attracts foreign funds. On the other hand, inadequacies in finance impede exploitation of opportunities, increase costs for enterprises and limit competition, and therefore innovativeness and productivity. However, financial services in most developing countries are inadequate and inefficient due basically to market failure arising from information asymmetry.

The study therefore looks at how short- and long-term efficiency, coverage and affordability of banking services in Kenya could be ensured through e-banking, trade and trade-related conditions, gradual and flexible liberalization, and regional, subregional and multilateral rules and commitments. It analyses (a) the main features of the sector; (b) the main players and their characteristics; (c) the legal and policy framework; (d) the regulatory and prudential institutions and the main challenges they face; (e) the performance trends over time and of domestically-owned banks relative to foreign ones; and (f) the implications of liberalization of banking services on sector stability and capital movements.

Executive summary

An overview

Globalization and the emergence of the digital economy (e-trade or e-commerce) have changed the way services business is conducted at national, regional, and international levels. The advent of WTO and the General Agreement on Trade in Services (GATS) agreement has assisted in defining services trade across country borders.

Within the GATS framework, countries have committed to progressive liberalization of trade in services. However, some developing countries, including Kenya, are becoming rather ambivalent about this because the benefits of liberalization affected to date are not obvious.

The services sector has been the most important sector in Kenya's economy in terms of employment creation, contribution to the gross domestic product (GDP) and foreign exchange earnings for most of the post-independence period. Moreover, the importance of the sector has increased over the period, with its share of GDP rising to 46 per cent by 1980, 58 per cent by 2002, and about 60 per cent by the end of 2005. The services sector's contribution to employment has been even larger, with its share in total wage employment rising from about 55 per cent in 1980 to about 62 per cent by 2004.

The contribution of the services sector to the Kenyan economy is, in relative terms, even more important with respect to trade balance. Thus, for most of the period since 1980, annual export of services accounted for about 50 per cent of foreign exchange inflows and about 25 per cent of the outflows in the country's current account.

This good performance of the services sector has not, however been reflected in substantial reduction in poverty in the country. Real GDP in the country grew at an annual average rate of about 3.3 per cent between 1972 and 2003, while per capita real income grew at only 0.2 per cent per annum. To make matters worse, this growth was not uniform, due to the country's vulnerability to internal and external shocks. About 56.8 percent of the population was living in absolute poverty in 2002, up from 45 per cent in the mid 1990s and 30 per cent in early 1970s. While the economy has continued to grow strongly since 2003, Kenya is still struggling to find a new path of sustained growth, with the latest effort being the ongoing development of a long-term strategy, Vision 2030.

Within this background, the main objective of this study is to provide an insight on the short- and medium-term implications of trade-related policies in tourism, telecommunications and banking services sectors on development of the sectors, socio-economic development of the country and poverty reduction. The analysis is expected to inform policy reforms and the country's negotiations of multilateral trade in services. These sectors were chosen on account of their importance in the country in terms of trade, provision of "infrastructure" type of services and the fact that these are the services the country liberalized early under GATS.

This overview briefly discusses the status of each of the services sectors studies and the key findings before attempting to synthesize the strategic issues that emerge from the case studies.

Tourism and travel services

As a development vehicle, tourism is a very attractive option for developing countries. Between 1990 and 2000, for example, the respective annual growth rates of tourism in these regions were 7.2 per cent, 6.3 per cent and 9.5 per cent, compared to only 3.4 per cent for Europe. Tourism is one of the key services sectors in Kenya, being the country's largest foreign exchange earner, the third largest contributor to GDP after agriculture and manufacturing, and having the largest trade surplus of all other services.

Kenya's tourism industry is built around the country's rich wildlife and beautiful coastal beaches. A great attraction of the country as a tourist destination is the fact that a tourist can enjoy a safari and the beach on the same trip.

Kenya provided all the necessary tourism and travel-related services. There are hardly any significant barriers, regardless of mode of supply, to foreign supply of tourism services in the country. The only limitations are with respect to mode 4 on movement of natural persons (all tourism services) and mode 1 (hotels, restaurants and catering services). The extent of liberalization of the sector is evident from the fact that, within the ongoing GATS 2000 negotiations, only the United States has requested Kenya to make further commitments in the sector.

However, there are some barriers in the form of requirements and restrictions. These include unspecified license requirements such as failure to spell out menus and managers' qualifications in the law on licensing of hotels and hotel managers, and discretionary power of the work permits committee of the Ministry of Tourism and Wildlife.

Industry consultations suggest that Kenya's GATS commitments on tourism have had no obvious impact, perhaps because the industry was already largely liberalized even before the commitments were made. However, as a result of many years of favourable policy environment for foreign investors and, later on, commitments under GATS, the industry is characterized by:

- Strong foreign presence;
- High degree of competition in the various segments, including high competition in some segments such as hotels, and competition from informal unlicensed "briefcase" operators, especially in tour operation and travel agencies; and
- Increasing use of the Internet, although this is constrained by inadequate bandwidth and connectivity.

The process of reversing commitments already made within GATS is time-consuming, costly and difficult. It would require renegotiations that could take at least 90 days, and commitment of other services as compensation for the reversal. This high cost of making a mistake has made the Government and private sector hesitant to make new commitments without thorough analysis of the likely implications.

There are considerable barriers to Kenya's tourism exports, including high outflow of earnings, competition from giant integrated suppliers in developed countries, discrimination in access to global distribution systems/computerized reservation systems, travel advisories, access to ancillary services to air transport and security measures, and other trade barriers, mainly in the form of restrictions on movement of professionals who supply tourism services, and restrictions of some forms of tourism business. The range of restrictions varies widely from one country to the next.

While the market access, national treatment and other barriers are critical, the most significant barriers for Kenyan tourism industry are capacity-related. Thus, the amount of challenge, competition and capital requirements that characterize operations in overseas markets put them in an entirely different league from the one the Kenyan businesses are currently playing in.
The way forward recommended for the sector consists of the following:

- Development of pro-poor strategies and policies to make the tourism sector efficient, viable and sustainable, both in the short and long terms. This should focus more on (a) the small and medium-sized enterprises (SMEs); (b) creation of strong linkages between the formal activities and the less formal community-based activities, through judicious use of incentives to stimulate local linkage and joint ventures; (c) capacity-building for SMEs; and (d) development of new tourism products on resources that the relatively poor have in abundance. Other strategies should include institutional reforms to improve efficiency and coordination, and development of partnership institutions.

- Review of all the laws and regulations touching on tourism to facilitate implementation of the pro-poor strategies and policies.

- Negotiation with development partners for assistance to address the considerable constraints to domestic supply capacity that exist.

- Persistent negotiation to have Kenya's trade partners ease or remove the restrictions they have in their markets. This is critical because trade expansion is crucial for the country to promote its domestic supply capacity. The country should negotiate for, among others, (a) credit for autonomous liberalization; (b) further developed country commitments, especially with respect to mode 4; (c) recognition of professional qualifications of tourism service suppliers; (d) increased supply of information, perhaps through WTO, on the demand for tourism services and the trade barriers in existence in developed country markets including support for the proposed GATS Annex on Tourism, increased technology transfer, removal of existing restrictions, greater liberalization of global air transport services (especially by developed countries), and emergency safeguard measures.

- Negotiation for adoption of measures to ensure gradualism and flexibility of tourism liberalization, including (a) making the process of revising or reducing commitments easier, to allow developing countries to correct mistakes made through commitments made earlier without adequate analysis and consultation; (b) improving and tightening GATS so that issues and positions are clear; (c) formulating a strategic approach to trade liberalization and foreign participation; and (d) developing an elaborate process of consultations.

Telecommunications services

Partial liberalization of telecommunications services in Kenya started in 1991, but only picked up substantially in 1999. The sector became fully liberalized in September 2004. However, the realities on the ground include a weak basic infrastructure base, existence of only one fixed-line telephony operator, unfair competition, weak human and other capacities, and inadequate understanding of the status and needs of the telecommunications sector, among others. As a result, there is very low fixed telephone penetration, with only 0.4 million lines in a country whose population is close to 35 million people. Mobile telephony is now the predominant telecommunications mode, with about 5 million subscribers currently, up from only 15,000 when liberalization was starting in 1999. Besides the increase in access, liberalization of telecommunications services has had other positive impacts, including (a) growth in micro and small enterprises in computer and related services; (b) considerable reduction in the price of telecommunications services; and (c) improvement in the efficiency of economic activities such as agriculture marketing, banking, and tourism.

However, the following challenges still need to be addressed:

- Archaic and weak infrastructure in some areas have meant that a big proportion of the population remains unserved, and that the country has not fully exploited the potential in call centers, data processing and data storage.
- There is poor connectivity within East Africa due to the absence of high-capacity optic fibre connectivity.
- There is a lack of legislation on e-commerce and e-Government.
- High tariffs and low service reliability are caused by inadequate competition in some subsectors.
- There are high taxes on air time and some information and communication technology (ICT) products.
- There is poor governance, insecurity and other weaknesses in the business environment.

Banking services

Financial services play an “infrastructure” role in driving trade and service, and are a key element of an enabling investment climate. Kenya’s banking sector has grown tremendously over the years and is largely liberalized. However, it remains highly concentrated, with the top 13 commercial banks controlling about 80 per cent of the deposits and about 73 per cent of the total assets in 2004. Considerable policy, legal and regulatory reforms have been undertaken in the country’s banking sector over time. As a result, the performance of the sector has improved in terms of availability of services and profitability, among others. However, low access of the poor to affordable financial services, high cost of financial services, high level of Government at the expense of the private sector, failure of banks to comply with licensing rules, high non-performing loans some banks, inadequate risk management mechanisms, and information technology risks, among others, remain notable challenges for the sector. Most of these are results of information asymmetry and inadequate competition in the sector.

To ensure short- and long-term efficiency, viability and sustainability of banking services in Kenya, the business environment has to be improved through (a) demonstration of political will and commitment in the repayment of non-performing loans; (b) finalization of the comprehensive financial sector development strategy that is underway (The strategy should recognize the varied needs of the diverse clientele in the country, the supply constraints largely caused by inadequate competition in the banking industry, the role that foreign firms can play and how they need to be organized or directed to play that role, and the regulatory and supervisory capacity and needs, among others.); (c) strengthening of existing institutions, particularly the Central Bank and development financial institutions (DFIs); (d) establishing those required for improving performance and services, such as public credit institutions; and (e) carrying out the required legal and regulatory reforms.

Although Kenya has committed to several banking services under GATS, greater commitments – especially with respect to national treatment – can increase competition. This should be complemented by commitments that encourage new entry in the formal banking sector. Such commitment does not take away the Government's authority to impose universal service obligations and necessary prudential measures.

However, the depth and speed of commitments should be balanced against the need to retain some bargaining chips for future multilateral negotiations. It should also be tempered by the fact that privatization and liberalization need to be gradual as regulatory and supervisory capacity is strengthened. In addition, to ensure gradualism and flexibility in liberalization, commitments to future liberalization should be considered as a way of preparing the industry and regulators by speeding up domestic reforms. An example of this would be committing to the removal of national treatment limitations that currently exist in less than 10 years.

Emerging strategic issues

The case studies show that trade-related policies in the tourism, telecommunications and banking services sectors may have had significant effects on development of the sectors, socio-economic development of the country and poverty reduction. This has been more evident in telecommunications, where service delivery improved, new businesses grew, the cost of the services fell, and often-marginalized segments of society were empowered following liberalization. It is difficult to discern the impact of commitments under GATS in sectors such as tourism that had been liberalized for a long time. In the case of banking, GATS commitments and previous autonomous liberalization do not seem to have had the desired impact because of other factors such as collusion, political interference and lack of a conducive investment climate in general.

The following lessons, which could be useful to other developing countries, stand out clearly from the case studies.

Trade barriers are important but domestic supply constraints are perhaps the bigger hindrance. There are considerable domestic supply constraints, mainly in the form of poor and inadequate infrastructure. This requires setting up special-purpose funds to cater for network development and expansion, especially in telecommunications. The funds can be established from government resources and from development assistance. Private sector investments in the rural area may not be profitable given the levels of poverty and economic activities. In the initial stages, therefore, the Government may either invest directly in those areas or provide appropriate incentives for the private sector to do so.

While the interventions suggested here are useful, addressing domestic supply constraints comprehensively calls for development of innovative sector strategies and establishing the legal, regulatory and institutional frameworks required for their implementation. For example, legislation on e-commerce and e-Government are long overdue. Associated with this is the need for capacity-building for regulatory and oversight institutions to cope with rapid progress in technology, particularly in telecommunications and banking. Developing countries should seek technical advice to build not only regulatory capacity but also domestic supply and negotiation capacity, and also to deal with problems such as non-performing loans. In addition, countries need to boost ICT human resources development through introduction of basic ICT training in formal education programmes.

Kenya needs to improve the business and investment environment for liberalization and other reforms to succeed. Such an environment would attract more investment, thereby increasing effective competition, reducing tariffs and improving service quality. Removal or reduction of taxes, political will and leadership are critical elements in the friendliness of the business environment.

Besides addressing development and domestic supply capacity issues, Kenya and other developing countries also need to be proactive and strategic about further liberalization of their services sectors. Firstly, the country should negotiate persistently to have its trade partners ease or remove the restrictions they have in their markets. This is critical because trade expansion is crucial for the country to promote its domestic supply capacity. Secondly, lack of capital and other capabilities among local investors suggest that the country needs to make commitments under GATS to facilitate participation of foreign investors rather than have unrealistic local shareholding minimum limits. This is particularly important and urgent for "infrastructure"-type services such as telecommunications and banking. Thirdly, services segments in which there is potential for local supply should be reserved for local SMEs and other local suppliers. Fourthly, the country should negotiate for development assistance to support strategic sectors or services, strategic either because of serving marginalized segments of the community that are targets of Millennium Development Goals or because they have potential for local supply. Fifthly, regional liberalization agreements and partnerships should be negotiated as a priority, as they are critical in building global supply or export competitiveness and capacity. Sixthly, policies, legal and regulatory frameworks in the region should be harmonized.

Further liberalization should be sequenced for the purpose of maximizing benefits. It makes sense to liberalize basic services such as telecommunications (or services where local supply capacity may be lacking), because they are critical for the further development and expansion of the services sector and the economy in general, and because local capacity to roll out such infrastructure is lacking. In addition, the depth and speed of commitments should be balanced against the need to retain some bargaining chips for future multilateral negotiations. It should also be tempered by the fact that privatization and liberalization need to be gradual as regulatory and supervisory capacity is strengthened.

Several steps are required to ensure gradualism and flexibility in liberalization. Firstly, there is a need to take stock of the impact past episodes of liberalization have had, as a confidence-building measure. Discussions with key public and private sector players indicate unambiguously that both sectors are scared of further liberalization of services within the multilateral framework because of ignorance about the likely impact. There is thus a need for detailed studies on impact of liberalization, identification of services with potential for local supply in order to ease doubt and indecision among developing country policy makers. A progressive liberalization timetable under GATS should accommodate these studies. Secondly, there is a need to consider commitments to future liberalization, as these may help to prepare the industry and regulators by speeding up domestic reforms. Thirdly, the process of revising or reducing GATS commitments should be made easier, to allow developing countries to correct mistakes of commitments made earlier without adequate analysis and consultation. Fourthly, GATS should be improved and tightened so that issues and positions are clear. Fifthly, a strategic approach to trade liberalization and foreign participation should be formulated. Finally, an elaborate process of stakeholder consultations should be developed.

Chapter one

Introduction and overview of the Kenyan economy

1.0 Introduction

Kenya is a member of WTO and signed GATS, which governs international trade in services, in 1994. Since then, it has made considerable commitments or liberalization of a significant number of its services sectors. Within GATS, countries have committed to progressive liberalization of trade in services. However, developing countries, including Kenya, are becoming rather ambivalent with respect to this, because the benefits of liberalization effected to date are not obvious.

The main objective of this study (rather three studies in one) is to provide an insight on the short- and medium-term implications of trade-related policies in the tourism, telecommunications and banking services sectors on development of the sectors, socio-economic development of the country and poverty reduction. The analysis is expected to inform requisite policy reforms and the country's negotiations of multilateral trade in services.

1.1 Overview of the Kenyan economy and economic policy

Kenya attained independence in 1963. Since then, the Government has been struggling with development challenges through numerous development plans, sessional papers, fiscal papers and recovery papers. These include Sessional Paper No. 10 of 1965 on "African Socialism and its Application in Planning and Management", Sessional Paper No. 1 of 1986 on "Economic Management for Renewed Growth", Sessional Paper no. 1 of 1994 on "Recovery and Sustainable Development to the year 2010", the Poverty Reduction Strategy Paper (PRSP) of 2002, and the Economic Recovery Strategy for Wealth and Employment Creation (ERS) of 2003, among many other national and sectoral strategy documents.

Over time, major policy focus has been on macroeconomic stability, poverty reduction or alleviation, enhanced trade, institutional reforms and private sector vibrancy to spearhead economic growth. Some of the key trade policy shifts occurred when the country abandoned import substitution and embraced export orientation and major economic liberalization, especially since the early 1990s when price controls and trade barriers came tumbling down. Economic reforms have continued since, albeit in a rather timid fashion.

1.1.1 Real and per capita GDP growth

These efforts saw strong economic growth, especially in the period following independence, averaging 6 per cent annually during the 1960s and 1970s. Real GDP in the country grew at an annual average rate of about 3.3 per cent between 1972 and 2003, while per capita real income grew at only 0.2 per cent per annum. This was not uniform, however, due to the country's vulnerability to internal and external shocks. Since independence, there have been distinctive phases of Kenya's economic performance:

- 1964–1973: decade of rapid growth.

- 1974–1979: phase characterized by external shocks, principally the oil price shocks of 1973 and 1979 and the coffee boom of 1978.

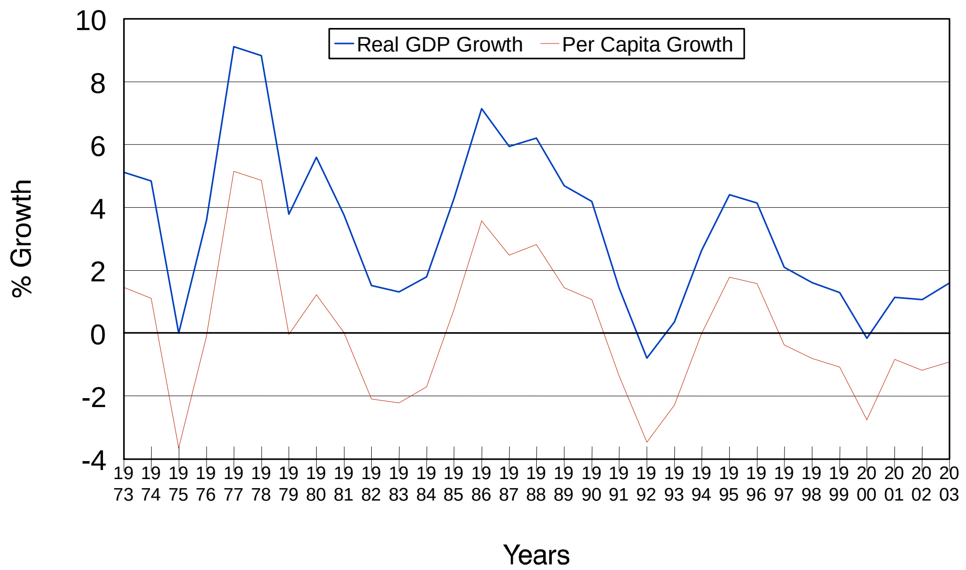
- 1980s: phase characterized by stabilization and structural adjustment.

- 1990s–2002: era of liberalization and declining donor funding; unprecedented internal and external shocks in the form of politically-related insecurity, freezing of donor funding, oil price increases associated with instability in the Middle East and the Gulf War, severe droughts in 1999 and 2000 leading to an energy crisis, *El Nino* floods of 1998 that crumbled infrastructure, and terrorism that led to negative travel advisories to potential international tourists, among others.

- Since 2003: era of governance by a different political party for the first time since independence. This was characterized by improved optimism in the populace, improved relationship with donors and resumption of aid, and more commitment towards better governance. The period has, however, also been characterized by high levels of insecurity and uncertainty associated with the constitutional review process.

These phases and the challenges associated with them (especially between 1974 and the early 2000s) led to erratic behavior, and a general declining trend of real GDP growth and per capita income growth (figure 1.1).

Fig. 1.1: Evolution of Real GDP Growth and Per Capita Income Growth



Source: Macroeconomics Division, KIPPRA.

Not surprisingly, therefore, real per capita income in 2003 was 3,347 Kenyan shillings (Kshs), which was below the levels registered in the late 1970s and 1990s. By 2002, about 56.8 per cent of the population was living in absolute poverty, up from 45 per cent in the mid 1990s and 30 per cent in the early 1970s. In the 40 years that the country has been independent, thus, Kenya moved from one of the most promising developing countries in sub-Saharan Africa, both in terms of growth and social development, to a stagnated economy, struggling to find a new path of sustained growth. Estimates by the Kenya Institute for Public Policy Research and Analysis (KIPPRA), of Kenya's potential output (total amount of goods and services that can be produced on a sustainable basis) reveal a declining trend. This implies lack of marked technological progress and inefficient utilization of resources. Studies also reveal that there has been a decline in output per worker as well as capital per worker from the late 1980s and 1990s.

The main reasons why economic performance has deteriorated so much include (a) tendency of stop–go policies, especially macroeconomic and trade policies; (b) slow pace of institutional reforms; (c) poor governance; and (d) effects of drought and floods, decline in external resources, declining levels of investment and productivity, low commodity prices, high population growth rate, HIV/AIDS pandemic, and a large refugee population due to regional insecurity. As a consequence, the country has been unable to maintain the basic public infrastructure and services developed in the past. The pace of reforms in general has been slow, mainly appearing to be pushed by donors, the private sector and civil society. A key challenge for the country is to implement economic and public sector reform programme, especially measures aimed at improving efficiency and public accountability.

1.1.2 Economic structure

Kenya has a diversified economy, with activities spread across agriculture, manufacturing and services contributing to GDP and employment. Table 1.1 presents the relative sector contribution to the country's GDP and employment in 2000 and 2004. From the table, it is evident that the main activities in the Kenyan economy include agriculture and forestry, manufacturing, trade and tourism, and services. While the relative importance of agriculture and forestry is declining, those of building and construction, trade and tourism, transport and communications, and financial and business services increased between 2000 and 2004.

Table 1.1. Structure of the Kenyan economy, 2000 and 2004

Sector	Contribution to GDP (%)		Contribution to wage employment (%)	
	2000	2004*	2000	2004*
Agriculture and forestry	28.4	23.7	18.4	18.2
Manufacturing	10.3	9.9	12.9	13.7
Building and construction	2.8	3.6	4.6	4.4
Wholesale and retail trade, restaurants and hotels	10.2	11.2	9.2	9.5
Transport and communications	8.9	10.3	5.0	5.6
Financial, insurance, real estate and business services	9.0	9.5	5.0	4.8
Community, social and personnel services[1]	12.6	18.7	43.2	42.3
Other sectors	17.8	13.1	1.7	1.5

* Provisional
Source: Kenya, *Economic Survey*, 2005.

1.1.3 Trade

Over the last decade or so, Kenya's trade position has been worsening. Thus, her trade deficit rose from $1.1 billion in 1995 to $1.8 billion in 2001 and further to $1.93 billion by 2004. The country's market for exports is rather narrow, with over 30 per cent of its total exports going to the United Republic of Tanzania and Uganda, and about 30 per cent to the European Union. With the end of non-reciprocal trade preferences in the European Union market by the beginning of 2008, Kenya's trade position is faced with considerable challenges. Until the early 1990s, Kenya's domestic

[1] This includes public administration and defense, education, health and social work, and other community, social and personal services.

industry had been protected by high tariff walls. Since 1993, however, the country's trade regime has been drastically liberalized through abolition of import licensing, elimination of tariffs for countries in the Common Market for Eastern and Southern Africa (COMESA) and East African Community (EAC) regional integration schemes, removal of quantitative restrictions, and reduction of the number of tariff bands.

1.2 Overview of services in the Kenyan economy

1.2.1 Contribution to GDP, employment and exports

The services sector has been the most important sector in Kenya's economy in terms of employment creation, contribution to GDP and foreign exchange earnings, for most of the post-independence period (table 1.2).

Table 1.2. Broad structure of the Kenyan economy, 1980–2000, % of GDP at factor cost

Sector	1960	1965	1970	1977	1980	1988	1990	2000	2002	2004*
Agriculture	38	35	33	35	33	31	29	20	24.0	23.7
Industry	18	18	20	20	21	20	19	18	18.0	18.3
(Manufacturing)	(9)	(11)	(12)	(12)	(12)	(12)	(12)	(13.1)	(13.0)	(14.2)
Services	44	47	47	45	46	49	52	62	58.0	58.0

* Provisional figures measured at market prices rather than factor cost.
Source: Ikiara et al. (2003) and updated from Kenya, *Economic Survey* (various issues).

The importance of the services sector, moreover, has steadily grown in the last four decades, with its share of GDP rising to 46 per cent by 1980 and 58 per cent by 2002. Its contribution to employment has been even larger, with its share in total wage employment rising from 55.4 per cent in 1980 to about 62 per cent by 2004 (annex table 1.1). The contribution of the services sector to the Kenyan economy is, in relative terms, even more important with respect to trade balance. Thus, for most of the period since 1980, export of services accounted for about 50 per cent of foreign exchange inflows and about 25 per cent of the outflows annually in the country's current account (annex table 1.2).

1.2.2 Policy evolution

At independence, the Government of Kenya recognized the critical contribution of the services sector in the economy, including its potential to improve the social, political and economic well-being of Kenyans. As a consequence of this and taking cognizance of the limited private sector capacity in the sector, the Government took the policy decision of delivering some of the services publicly. The required legal and institutional frameworks were put in place under specialized parastatals. In telecommunications services, for instance, the Kenya Posts and Telecommunication Corporation (KPTC) was established to provide fixed-line telephone services. With time, however, there was need for the Government to introduce policy reforms due to increased private sector capacity, market demands, technology change, and the need to modernize in order to fit into the global arrangements. In 1991, for example, the Government liberalized the non-strategic telecommunications networks by opening up the value added service market. In the meantime, the African Regional Center (a non-governmental organization (NGO)) and Africa Online (a small private company) pioneered provision of cellular services in 1992. This marked the beginning of value added services, though the legislative and regulatory framework had yet to be put in place.

Liberalization was deepened in 1994, when Kenya signed GATS and made the initial commitments in tourism and a few other services sectors. There was very little understanding, in the country, about multilateral trade agreements in general and GATS in particular, however. The Communications Act of 1998, for instance, brought on board GATS global dimensions of liberalization, competition and to some extent privatization, with the effect of expanding coverage to include broadcasting and new services in Internet and other related valued added services. The concomitant reforms in support of the new policy changes ended public sector monopoly with the establishment of regulators to oversee wider participation of the private sector and the diversification of the service and product range.

1.3 Services sectors of trade interest to Kenya

The most important services with respect to contribution to GDP and wage employment are (a) community, social and personal services; (b) trade, restaurants and hotels; and (c) transport and communications. As pointed out already, financial services are also very important. Transport, tourism and telecommunications services are the top three service exports in the country, while insurance, transport and travel (tourism) are the top three service imports. Tourism exports were 16–46 per cent of the country's exports of goods between 1980 and 2004, with 1990 being the peak period (table 1.3). The corresponding figures for transport services were 54.1–132.9 per cent over the period, with the peak in 2000. The significance of communications has increased progressively over the period, reaching a peak in 2002 (table 1.3). Foreign travel/tourism enjoys the largest net surplus, followed by telecommunications services, while the largest net deficit has been recorded in insurance and royalties and license fees (WTO, 1999).

Table 1.3. Tourism and transport earnings in Kenya's total exports and GDP

	1980	1985	1990	1995	2000	2002	2004
1. Total GDP (at market prices) (Kshs millions)	2,632.0	4,810.0	9,939.0	23,282.0	34,271.8	42,545.5	63,685.8
2. Export of Goods (Kshs millions)*	516.0	746.0	1,158.0	4,822.0	6,726.4	8,464.1	10,720.1
3. Tourism earnings (Kshs millions)	83.0	204.0	533.0	1,250.0	1,011.8	1,631.9	1,960.0
4. Transport earnings (Kshs millions)	279.4	551.7	1,099.1	2,230.7	8,938.8	9,752.0	12,521.0
5. Communications earnings (Kshs millions)	57.5	114.6	288.9	805.1	1,403.2	2,501.1	2,860.4
6. Total Assets in the current account (Kshs millions)**	1,163.9	1,566.2	3,596.5	10,127.6	15,176.6	15,847.3	20,881.8
7. Share of services in the total assets, %	14.5	22.1	36.1	33.0	23.6	21.5	18.1
8. Tourism as % of GDP	3.2	4.2	5.4	5.4	3.0	3.8	3.1
9. Tourism as % of export of goods	16.1	27.3	46.0	25.9	15.0	19.3	18.3
10. Transport as % of GDP	10.6	11.5	11.1	9.6	26.1	22.9	19.7
11. Transport as % of export of goods	54.1	74.0	94.9	46.3	132.9	115.2	116.8
12. Communications as % of GDP	2.2	2.4	2.9	3.5	4.1	5.9	4.5

Source: Kenya, *Economic Survey* (various issues).

Tourism and telecommunications services were chosen for this study primarily because they are of major trade interest for the country, particularly on account of their large trade surpluses. In addition, telecommunications are an important "infrastructure" type of service whose efficiency drives all other sectors of the economy. The importance of telecommunications is demonstrated, moreover, by the fact that the Government, in 2004, set up a separate ministry for coordinating information and broadcasting issues.

* This is composed of exports and re-exports on FOB basis but does not include exports of services.

** This includes exports of goods and services (both private and government), income inflows and current transfers (private and government).

The importance of ICT, particularly telecommunications, in National Development is well documented in many studies around the world, notably by the International Telecommunication Union (ITU) and the World Bank. Many studies have demonstrated a correlation between ICT development and economic growth and development. For example, by January 2000, of the world's 6 billion people, 15 per cent lived in high-income countries. These high-income countries had 58 per cent of the world's fixed telephone lines, 69 per cent of the mobile phones and 82 per cent of the Internet users. On the other hand, 60 per cent of the 6 billion people lived in low-income countries, and had only 30 per cent of the world's telephone lines, 20 per cent of the mobiles and 10 per cent of the Internet users. The United Nations recognizes the importance of ICT globally, as demonstrated by the World Summit on Information Society (WSIS) which it hosted and its incorporation of ICT as part of the Millennium Development Goals.

Besides making a large contribution to GDP, financial (banking) services were also chosen because of their "infrastructure" type of service role. Another motivation for the study is that, as important as the chosen services sectors are, they are still affected by inadequate national infrastructure capacity, lack of policy frameworks, and weaknesses in the legal, regulatory and institutional frameworks. In addition, these sectors were some of the ones to which Kenya made early commitments within GATS, and trading partners such as the European Union and the United States have made requests, within the framework of the ongoing GATS 2000 negotiations, for further liberalization.

Chapter two

Tourism and travel-related services

2.0 Introduction

Tourism is one of the world's largest and fastest growing industries. World Tourism Organization (UNWTO) data shows that by 2002–2003, international tourist arrivals (which constitute only 20 per cent of total tourist activity) had reached about 700 million and receipts of $474 billion, larger than the export value of any single category of product or service, including petroleum (Ikiara, 2005). As a development vehicle, tourism is a very attractive option for developing countries. This is evident by the strong growth performance achieved by the sector in Asia and the Pacific, and Africa and the Middle East in the 1990s. Between 1990 and 2000, for example, the respective annual growth rate of tourism in these regions were 7.2 per cent, 6.3 per cent and 9.5 per cent compared to only 3.4 per cent for Europe (Ikiara, 2005). As a consequence, these regions have increased their shares of the global tourism market significantly. Furthermore, tourism receipts for the 49 least developed countries more than doubled in the 1990s, rising from $1 billion in 1992 to over $ 2.2 billion in 1998. Perhaps more importantly, tourism is the only major services sector in which developing countries consistently record trade surplus relative to the rest of the world, with their travel account surplus growing from $4.6 billion in 1980 to $65.9 billion by 1996 (Neto, 2003).

In addition, international tourism spurs development by generating substantial tax revenues, stimulating regional development, including marginal areas often rich in natural and cultural assets but with limited alternative development options, and generating employment owing to its highly labour-intensive nature.

This chapter looks at how trade-related policies and other interventions could be used to spur further development of tourism in Kenya. More specifically, the chapter analyzes the structure of the sector, particularly its legal and regulatory structure, how liberalization has impacted on its performance, the explicit and implicit regulatory and other barriers to trade in tourism services, the evolution of policy, especially that concerning sector competition and liberalization, and then makes recommendations on the kind of policy and regulatory interventions, international support or complementary actions, and rules and commitments required to ensure short- and long-term efficiency, viability and sustainability of tourism in the country.

2.1 Overview of the importance and structure of the tourism sector

For many years, Kenya's development objectives have been and continue to be poverty reduction or alleviation[2] and employment creation. Without doubt, tourism has contributed considerably to these objectives. Indeed, in the current economic recovery strategy (2003–2007), tourism is one of the leading sectors expected to play this role. It is one of the key services sectors; it is the country's largest foreign exchange earner (after tea and horticulture), the third largest contributor to GDP after agriculture and manufacturing, and has the largest trade surplus of all other services.

[2] This changed to wealth creation in the latest economic blueprint, the *Economic Recovery Strategy for Wealth and Employment Creation 2003–2007*.

The World Travel and Tourism Council (WTTC), using the satellite accounts method, which is able to capture both direct and indirect contributions of tourism, estimated that travel and tourism (a) contributed Kshs 74.6 billion to the country's GDP, or 8.7 per cent of the total GDP; (b) generated Kshs 109.1 billion in total economic activity; (c) accounted for 19.2 per cent of the country's total exports; and (d) accounted for 6.8 per cent of total employment in 2002 (WTTC, 2002). In 1998, it was estimated that, of the more than 500,000 jobs created in tourism, 360,000 were in the formal sector and 138,000 in the informal sector (TTC, 1998). Besides these contributions, tourism promotes the Kenyan culture.

2.1.1 Historical overview

Tourism in Kenya can be traced to 1909, when American President Theodore Roosevelt visited the country on an expedition to collect natural specimens for American museums. Other great people who visited the country and left with fond memories of its amazing natural heritage include Sir Winston Churchill, Ernest Hemingway, and the United Kingdom's Queen Elizabeth II. The queen, in fact, learnt of her accession to the British throne while on holiday in Kenya.

The colonial Government founded Kenya's tourism on strong wildlife conservation in particular and biodiversity conservation in general. Thus, several game ordinances (including the East African Wildlife and Bird Protection Ordinance of 1903, and the Game Ordinance of 1909 that created the southern and northern reserves) were made to address wanton killing of wildlife. The first national park, the Nairobi National Park, was opened in 1946, followed by Tsavo National Park the same year. In the subsequent decades, the country established a total of 59 national parks and game reserves, which account for about 11 per cent of the country's surface area (Kenya, 1997). This transformed the destination of Kenya into what would later be referred to as the "nature's wonderland", which constitutes one of the sector's main features.

2.1.2 What the country offers

Kenya has a lot to offer tourists. Its tourism industry is built around the country's rich wildlife and beautiful coastal beaches. The greatest attraction of Kenya as a tourist destination is the fact that a tourist can enjoy a safari and the beach on the same trip. Thus, even though the coast accounts for about 60 per cent of all bed nights in the country, the prime motivation for 70–80 per cent of all tourists visiting the country is wildlife (Ikiara and Okech, 2002). In fact, there is scope to increase this value with regional cooperation. On account of the three East African countries being only short distances away, well connected by air, and with the East African Community being operational, tourists visiting East Africa have the option of viewing the famed gorillas in Uganda, and the spectacular Kilimanjaro in the United Republic of Tanzania. Besides rich wildlife, tropical weather and beautiful coastal beaches, Kenya's strong base for tourism development includes:

- Very diversified culture in the country's 42 tribes;
- The impressive Mount Kenya and access to the world famous Mount Kilimanjaro;
- The Great Rift Valley and its associated spectacular landscape;
- The world's second largest fresh water lake (Lake Victoria);
- The fact that the equator runs through the country; and
- Historical and cultural resources, including museums and historical sites.

The national tourism master plan identified no less than 120 major tourism destinations and spots in the country, including 84 national parks and reserves (Government of Kenya, 1995). According to the master plan, Kenya is competitive in such tourist market segments as mountain and highland resort tourism, special interest tourism (such as archaeology, ethnology, ornithology, botany and zoology), rail safari, cruises and activity holidays. The country is also fairly competitive in conference tourism, mainly because Nairobi is a regional air transport hub, has relatively sophisticated conference facilities and has experience hosting international conferences. It is the only developing city in the world that hosts two United Nations bodies: the United Nations Environmental Programme (UNEP) and the United Nations Centre for Human Settlements (UNCHS-Habitat).

Most of this potential has not been exploited, however. Government plans to develop and promote new tourism products have remained just plans. Such products include golfing, eco-tourism safaris, the Safari Rally, cruise shipping, cultural activities such as bull fighting and food festivals, agro-based tourism products (such as coffee, tea, pyrethrum and pineapple plantations), Kakamega tropical forest (that hosts unique bird, butterfly and indigenous tree species), athletics-based tourism, and nature-based attractions such as the "weeping stones" of Vihiga in Western Kenya. The tourism potential associated with the country's monuments, antiquities and historical resources has also not been fully tapped, largely because of inadequate interpretive material and innovativeness, corruption and inadequacy of resources. Although the country has at least 141 major cultural and historical resources, only 71 national museums and monuments are marked for preservation. Furthermore, only 16 of these are utilized for tourism and only on a limited scale. Despite this low level of utilization, at least 60 per cent of the international tourists who enter the country yearly visit museums, monuments and other historical sites.

2.2 Main players and the legal and regulatory framework

The private sector, which has gained considerable experience and capacity, has been the main driver of the Kenyan tourism industry. The public sector has also played a major role, especially when the industry was young. With privatization, however, the role of the public sector is progressively declining to a mainly policy and regulatory one.

2.2.1 The public sector

The public sector has, over time, played a major role in the development of tourism in Kenya. It has done this through policy formulation and implementation, regulation of the industry, provision of infrastructure and some superstructure, as well as management and maintenance of the natural resource base and tourism attractions. Initially, the Government was heavily directly involved in the tourism business, including hotels, lodges, tour operation and extending credit facilities to the private sector. However, following the implementation of the structural adjustment programme in the early 1990s, the Government continues to divest out of these enterprises to concentrate on the roles of formulating and implementing policy, regulating the industry, supporting and promoting tourism, licensing industry players, providing the necessary infrastructure and ensuring fair play in the industry (Ikiara, 2005). In general, the main role of the Government now is to provide an enabling environment for sustainable tourism to thrive in the country.

The main public sector players in Kenya's tourism industry include the Ministry of Tourism and Wildlife, the Kenya Tourist Board (KTB), the Kenya Wildlife Services (KWS), Kenya Tourist Development Corporation (KTDC), Utalii College, and the National Museums of Kenya (NMK), among others. These are briefly described below.

2.2.1.1 Ministry of Tourism and Wildlife

Over the years, the Ministry of Tourism and Wildlife has played an important role in the development of tourism as outlined below:

- **Planning and policymaking:** In collaboration with relevant stakeholders, the ministry is in charge of overall tourism and wildlife policy formulation, implementation, monitoring and review.
- **Overall coordination:** The ministry liaises with international and regional organizations and Governments on tourism and wildlife issues. It coordinates all tourism and wildlife-related efforts of all government departments and related institutions. It also liaises with NGOs, community organizations, international organizations such as UNWTO and other related bodies.
- **Resource mobilization:** The ministry is responsible for seeking finances from internal sources for the development of tourism and wildlife.
- **Facilitation:** As part of its facilitative role, the ministry ensures allocation of resources for tourism and wildlife development, safety and security of tourists, and conservation of biodiversity. In addition, the ministry promotes and facilitates local and foreign investments in tourism, and establishes enabling and appropriate legal and fiscal frameworks for tourism development and wildlife management.
- **Marketing and promotion:** The ministry ensures promotion of both domestic and international tourism. In the discharge of this responsibility, it works closely with the private sector, other ministries and government agencies (such as the Ministry of Foreign Affairs and International Cooperation, Ministry of Environment and Natural Resources, Ministry of Local Governments, Investment Promotion Council, Export Promotion Council and the Kenya Tourist Board).
- **Regulation and monitoring:** The ministry's regulatory and monitoring role includes setting standards for hotels and restaurants, and regulation of tourist enterprises and wildlife sector.
- **Product development and diversification:** The ministry ensures development of all destinations with potential for tourism and promoting communities' involvement in tourism.
- **Manpower Training and Development:** The ministry is responsible for training of manpower and setting of standards in the hospitality industry and the wildlife sector.

The ministry regulates the industry through two main pieces of legislation:

- The Tourist Industry Licensing Act (CAP 381) of 1970 (revised in 1990), which licenses tourism enterprises and generally regulates the private sector (tour operators, travel agents, tour guides, curio dealers, and charter planes, among others). The Tourist Industry Licensing Authority (TILA) is the body, under the Department of Tourism, that plays this role.
- The Hotels and Restaurants Act (HRA) (CAP 494) of 1972 (revised in 1986) that provides for (a) the licensing of hotels, lodges and restaurants; (b) classification of hotels and restaurants; (c) collection of training levy from hotels, lodges and restaurants; and (d) establishment of the Utalii College. Hotel managers are also licensed under this legislation upon acquisition of a work permit in the case of foreigners. The Hotel and Restaurants Authority, established by this Act within the Department of Tourism, thus issues three licenses: hotel license, restaurant license and hotel manager's license.

This Hotels and Restaurants Act has some shortcomings in that its does not provide for licensing of private home stays, private sanctuaries, private villas and hotels with less than five beds, which makes it difficult for the ministry to regulate these facilities. The facilities, which account for a significant albeit unknown proportion of tourism services, give the licensed businesses unfair competition in terms of payment of licensing fees.

The draft tourism policy recognizes this shortcoming and provides for the revision of the act, and the authority acts to accommodate regulation of these facilities. In addition, the draft policy calls for reduction of the "multiplicity" of licenses and consolidation of the legal and regulatory framework for the tourism industry in a single comprehensive Tourism Act. In fact, a Working Group Committee on Tourism Institutional and legal Framework was formed in 2004 to work on the reforms concurrently with the finalization process of the tourism policy. The group was expected to submit the report to the ministry by 31 July 2005.

The Hotels and Restaurants Act has a Hotels and Restaurants Committee on Work Permits, which assesses work permit applications by foreign hotel managers and other professionals. The technical committee makes its assessment on the basis[3] of:

- Whether the hotel manager or other employee is coming to represent the interest of the overseas proprietor or investor; and
- Whether the applicant has certain skills that are not locally available (regulation 23 of the HRA), including language and specialized cuisine.

The findings of this committee are usually forwarded to the principal immigration officer, who then presents them to the Immigration Committee on Work Permits for decision. If the applicant meets any of the two criteria, he/she can be issued with a work permit for a period of up to two years when a Kenyan is understudying him. The Kenyan may then replace the expatriate on the expiry of the work permit, if the credentials of the understudy satisfy the committee.

The time it takes to obtain a work permit[4] and the lack of transparency of the process are obstacles cited by the tourism industry. This is largely due to weak capacity in terms of personnel, training and funding, and poor governance. Like the rest of the civil service, the Ministry of Tourism and Wildlife suffers from lack of inadequate resources, with most of the resources going to recurrent expenditure (mainly salaries), inefficiency and inability to retain highly qualified staff. In addition, there is often a lack of adequate clarity over roles leading to conflict, duplication and poor coordination. The requirement that the company seeking the work permit must place an advertisement in the print media to ascertain lack of qualified Kenyans for the job, moreover, imposes high costs to the company.

Although the work permit problem is not very serious, judging by interviews with the industry participants, the draft National Tourism Policy document 2004 provides for strengthening of the work permit process "to ensure that employment opportunities for Kenyan citizens are maximized" through economic needs tests.

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[3] Foreigners seeking employment in tourist industry establishments licensed under TILA Act are subjected to the same vetting process provided under the Hotels and Restaurants Act, although the former act does not provide for it.

[4] On average, however, the processing of the work permit application takes two weeks.

2.2.1.2 Kenya Tourist Development Corporation

Established under Kenya Tourist Development Corporation (KTDC) Act (CAP 382)[5] in 1965, KTDC is a State-owned enterprise in charge of spearheading tourism developments through marketing Kenya as an investment destination and providing equity and loan funding to tourism projects in Kenya. The main objective was to improve the indigenous presence in the tourism industry. The functions of KTDC include:

- Research to identify opportunities, trends and priorities in the tourism sector;
- Linkage of the public and private sectors in the development of tourism facilities;
- Facilitation of information exchange among industry shareholders in order to promote development and diversification;
- Provision of financial instruments (in form of loans and/or equity participation) to cover short and long-term investor needs; and
- Provision of legal, business and market advice to assist investors to identify and implement profitable ventures.

KTDC played a major role in tourism development, especially in the 1960s and 1970s. Many tourist facilities were established with the assistance of the corporation. Through KTDC, the Government became a major participant in the ownership and management of tourism enterprises in the period between independence and the early 1990s. Thus, by 1992 the Government had partial or full stakes in 32 hotels with a capacity of 5,760 beds, almost 13 per cent of the total.

With time, however, the corporation suffered from mismanagement and political interference with its investment and lending decisions. According to Honey (1999), for instance, instead of KTDC buying shares from foreign-owned tourist establishments and selling them to promising Kenyan entrepreneurs at a special rate, the corporation subsidized businesses owned by the powerful, rich and politically connected. As a result, foreign investors had an incentive to form partnerships with the rich and powerful politicians and businessmen. As part of the government privatization policy, KTDC is currently divesting from several businesses, including 200 budget hotels, which were established in partnership with local authorities and private individuals. This is expected to provide a good opportunity for local host communities to own these businesses and thereby fulfill the corporation's initial objective. The corporation is being restructured and refocused to play its role more effectively.

2.2.1.3 Kenya Wildlife Service

The Kenya Wildlife Service is a State Corporation established by Wildlife Conservation and Management Act (WCMA), CAP 376 of 1977 (revised in 1985)[6], with the mandate to:

- Formulate policies regarding the conservation, management and utilization of all types of fauna and flora (excluding domestic animals);
- Advise the Government on establishment of national parks, reserves and other protected wildlife sanctuaries;
- Manage national parks and reserves;

[5] This Act provides the legal framework for the development of public tourism enterprises in the country.
[6] The act provides a framework for wildlife conservation and management.

- Prepare and implement management plans for national parks and reserves and the display of fauna and flora in their natural state for the promotion of tourism and for the benefit and education of the inhabitants of Kenya;
- Provide wildlife conservation education and extension services to create public awareness and support for wildlife policies;
- Sustain wildlife to meet conservation and management goals;
- Conduct and coordinate research activities, conservation and management;
- Identify manpower requirements and recruit manpower at all levels for the service, for wildlife conservation and management;
- Provide advice to the Government, local authorities and landowners on the best methods of wildlife conservation and management, and the principle instruments of the Government in pursuit of such ecological appraisals or controls outside urban areas as are necessary for human survival;
- Administer and coordinate international protocols, conventions and treaties regarding wildlife in all its aspects in consultation with the minister;
- Solicit – by public appeal or otherwise – and accept and receive subscriptions, donations, devices and bequests for the general or specific purposes of the service or subject to any trust; and
- Render services to the farming and ranching communities in Kenya necessary for the protection of agriculture and animal husbandry against destruction by wildlife.

KWS is thus another major regulatory agency in the country's tourism sector. It enters into lease arrangements with lodges located in national parks and regulates wildlife conservation for tourism purposes. For instance, it licenses private ranches as well as individual activities such as crocodile and ostrich farming. It also regulates game cropping for consumptive use.

Before KWS was established in 1989, the Wildlife Conservation and Management Department (WCMD), established in 1976, carried out the above mandate. The performance of WCMD, however, came into question after poaching activities increased and it was apparent that the department was "unable to guarantee the safety for tourists and address their growing dissatisfaction with poor facilities" (Honey, 1999:299). While KWS largely addressed these weaknesses, the organization is unsustainable, as it depends heavily on donor funding. In addition, it has faced serious challenges related to political pressure, frequent change in its leadership, poor governance and in handling human–wildlife conflicts and the related compensation issues, inadequate staff, marketing and pressure from poachers.

There has been considerable pressure and effort to amend WCMA to clarify ownership rights for wildlife on private land, improve wildlife management and conservation, and address the human–wildlife conflict. These have not borne fruit yet, however. A bill for this purpose was passed in Parliament but vetoed by the President, who felt that it needed further fine-tuning.

2.2.1.4 Kenya Utalii College

The Kenya Utalii College was established in 1975 under the HRA, with the objective of enhancing professionalism and improvement of standards of services in the tourism and hospitality sector, through training and consultancy services. Since its establishment, the college has played an important role in manpower development for the expanding industry. In 2001, for example, it trained a total of 1,219 professionals. Most of the college's graduates are highly qualified and valued by the tourism industry for their professionalism. Some have landed jobs even outside the country, for example in the United Kingdom. The college is recognized by UNWTO as a center of excellence, and is a regional tourism training college. It will soon start awarding degree courses in tourism. Because of limited admission places, it is very competitive, and is also expensive. Plans are underway, however, to establish a constituent college in Mombasa. The college receives the bulk of its funds from the catering and tourism development levy trustees (CTDLT).The college is constrained by capacity limitations in terms of adequate funding, classes, and the capacity of the Utalii Hotel for practical training and staff. These are issues that need to be addressed urgently as the college trains even for neighbouring countries.

2.2.1.5 Catering and Tourism Development Levy Trustees

CTDLT was established through HRA to control and administer the Levy Fund, with the overall objective of establishing, equipping and controlling establishments for training of personnel required in hotels and restaurants. The training levy is collected from 2 per cent of the gross turnover of all hotels and restaurants.

2.2.1.6 Kenya Tourist Board

KTB, established through Legal Notice No. 14 of 17 February 1997, is charged with promotion and marketing Kenya as a preferred tourist destination, both locally and internationally. The board is a public–private partnership funded by the Kenya Government through the normal budgetary provisions (for operations and maintenance). In addition, it receives some limited funding from the CTDLT as well as the private sector (Kenya Airways among others). The European Union (EU), on the other hand, funds tourism marketing and promotion activities. The EU has also funded the development of KTB's state of the art website, MagicalKenya. KTB is making efforts at marketing the country but is constrained by lack of adequate funds.

2.2.1.7 Tourism Trust Fund

TTF is a joint initiative of the European Union and the Government of Kenya. It was established in December 2001 and officially launched in January 2003. Its objectives are to:

- Broaden the range of new and innovative commercially viable and economically sustainable tourism products, including eco-sensitive, community-based and locally-owned tourism ventures[7];
- Create new income and employment opportunities that will contribute to poverty reduction and economic growth;
- Establish a sustainable base for repositioning and revamping Kenya as a tourist destination; and
- Provide resources to support regional and international marketing of the destination.

In late 2003, through TTF, tourism promotion and marketing was funded to the tune of Kshs 500 million and fruits of this effort have been clearly evident since 2004. The ongoing tourism boom is largely attributed to this effort. TTT also funds the development of tourism policy and supports diversification of tourism products through development of new products such as adventure tourism (e.g. "bicycle safaris" day trips on bicycles).

[7] Delegation of the European Commission in Kenya website: http://www.delken.cec.eu.int/en/eu_and_kenya/cooperation/tourism.htm.

2.2.1.8 Tourist Police Unit

The idea to establish the Tourist Police Unit was broached in 1992 to enhance safety and security of the tourists in the country. Later, a memorandum of understanding was signed between the Commissioner of Police and the Permanent Secretary, Ministry of Tourism and Wildlife, to establish the unit. Its functions include:

- Provision of security to tourists and their property through patrols in areas used by tourists, provision of escorts to tourists, receipt and handling of claims and complaints (including inquiries) by tourists, investigation of crimes, prosecution of offenders;
- Protection of tourists from harassment by beach operators, parking boys and hawkers;
- Enforcement of local authority by-laws;
- Offering general advice and guidance to tourists, including assisting them during cultural festivals;
- Detection and prevention of overcharging of tourism sector goods and services; and
- Handling various other issues concerning tourism, in consultation with the Ministry of Tourism and Wildlife.

The unit, which is based at the Ministry of Tourism and Wildlife Headquarters, recruited 300 police officers in 2003. In addition, it has already offered 160 police officers a course on tourism sensitization. Some officers have also taken courses on protective security survey and counter terrorism techniques mounted by Scotland Yard. The unit plans to open offices in other important tourist areas in the country, including Lamu, the Mount Kenya region and the Masai Mara area. The unit is a laudable idea, considering the serious impact insecurity has continued to have on the country's tourism sector over the years. Ikiara et al. (forthcoming), for example, estimate that a 1 per cent increase in the number of reported robberies (measure of insecurity) reduces tourism receipts by 0.7 per cent. The main bottleneck the police unit is facing is adequacy of funding. Thus, for example, the force is yet to be fully equipped with the necessary working tools, offices and housing. If overall security is not improved in tandem with that of tourists, moreover, the value of tourism in the country could be affected by enclave concerns.

2.2.1.9 Kenyatta International Conference Centre

The 32-storey complex, which encapsulates the traditions, aspirations and environment of the people of Kenya, caters to the needs of modern conference organizers in terms of space, administration and ancillary requirements. The centre was established as a state corporation through Legal Notice No. 77 of 9 July 2004. Its mandate is to:

- Rehabilitate, manage and maintain the building and its facilities effectively and efficiently;
- Market the available conference facilities both locally and internationally, so as to promote conference tourism;
- Determine competitive charges for use of the facilities; and
- Liaise with relevant stakeholders for timely and efficient service delivery.

2.2.1.10 Bomas of Kenya

Bomas of Kenya was established in 1972 as a wholly owned subsidiary of KTDC, with a principal function of developing and promoting Kenya's cultural values. Its mandate includes development and promotion of Kenya's rich cultural heritage as a tourism product, while ensuring that such development is sustainable. It has a popular facility for cultural tourism within a few kilometres from the Nairobi city centre, which is planned to be enhanced by the addition of a high-class restaurant.

Despite the existence of Bomas of Kenya, the potential of cultural tourism in the country remains largely untapped, due to technical and financial capacity limitations.

2.2.1.11 National Environment Management Authority

Besides the Ministry of Tourism and Wildlife and KWS, the National Environment Management Authority is emerging as the other main regulatory institution in Kenya's tourism industry. In spite of the fact that tourism and environment are inseparable, environmental issues are not clearly provided for in the two main pieces of tourism legislation (HRA and TILA). However, the draft National Tourism Policy provides for strong environmental protection and management based on provisions made in the Environmental Management and Coordination Act of 1999. This act requires environmental impact assessment studies of planned projects, including tourism projects. It also provides for annual environmental audits by businesses, including tourism enterprises, and strategic environmental assessment of policies, programmes and plans. It established the authority as the enforcement agency.

While the Environmental Management and Coordination Act and the National Environment Management Authority are evidently crucial for sustainable tourism development in the country, capacity weaknesses remain considerable bottlenecks. The authority is yet to develop important environmental standards for various economic sectors and frameworks of applying economic instruments in the management of environment and natural resources. It lacks adequate technical staff in various disciplines.

2.2.1.12 Other public sector players and laws

Other public sector players include (a) National Museums of Kenya, whose responsibilities are management and conservation of monuments, antiquities and historical resources under the Antiquities and Monument Act (CAP 215, Revised Edition of 1984); and (b) local authorities, who are charged with the responsibility of managing wildlife reserves such as the world-famous Maasai Mara, and also urban areas including Nairobi. There are many other public institutions that play varied roles in tourism, albeit as part of their broader mandates. These include the Investment Promotion Centre, which is charged with the responsibility of promoting private (local and foreign) investment in all sectors of the economy, and the Export Promotion Council, which promotes exports. Besides the main pieces of legislation cited already, moreover, many other laws affect the tourism industry in the country. Indeed, it is estimated that there are no less than 22 laws that impact on the industry, with some of them dating back to the colonial times (Ikiara, 2005).

2.2.2 The private sector

The private sector, comprising both local and foreign operators, has invested in the hotels, lodges, campsites, tour companies, travel agencies, private ranches, nature reserves, air and road transport companies, curio and handicraft enterprises, farms and other facilities that constitute the tourism industry. The country can boast of the presence of major international hotel chains such as Hilton and the Intercontinental, and many local high-class hotels such as the Grand Regency and Serena. The private sector plays such other roles as promoting and marketing the industry, and supporting wildlife and culture conservation with considerable external costs. The pursuance of profit maximization by the private sector in an environment of weak or absent regulatory oversight has, however, led to overdevelopment in the key tourist attractions, with heavy environmental and social cost (Ikiara, 2005). It has done this through individual businesses and industry associations, which we discuss briefly below.

2.2.2.1 Kenya Association of Tour Operators and Kenya Association of Travel Agents

There are close to 3,000 registered tour operators and many travel agents in the country. The Kenya Association of Travel Agents (KATA) and the Kenya Association of Tour Operators (KATO) articulate the interests of these tour operators and travel agents. Membership levels are, however, low and declining due to weak organization and capacity. KATO was formed after the collapse of EAC in 1977. This collapse led to the breakup of the East African Tour Operators Association, which was the precursor of KATO. The association represents about 200 tour operators and aims at pursuing the following major objectives:

- Promote Kenya as a prime destination in all trade markets worldwide;
- Ensure that a high standard of service is offered by the Kenya travel industry; and
- Uphold the business ethics of the travel profession.

The association is also committed to eco-tourism, as it conducts extensive training for driver-guides who take the visitors to eco-tourism sites. In addition, the association has a voluntary code of environmental conduct for both visitors and tour guides. In playing this noble role, however, KATO is constrained by the fact that it has control over its members only, which is a small proportion of the total. KATA is an association of travel agents, which articulates the interest of its members.

2.2.2.2 Kenya Association of Hotelkeepers and Caterers and Kenya Association of Budget Hotels

The country has the Kenya Association of Hotel Keepers and Caterers and the Kenya Association of Budget Hotels to encourage, promote and protect the interests of hotel, restaurant and related businesses owners. The Kenya Association of Hotel Keepers and Caterers is committed to eco-tourism principles and encourages its members to save energy and water, reduce waste and other forms of pollution, and create environmental awareness among its staff and visitors. However, since these guidelines are voluntary, the organization lacks authority to enforce them.

2.2.2.3 Eco-tourism Society of Kenya

The Eco-tourism Society of Kenya was founded in 1992 as a forum for bringing together the tourism industry, conservationists and host communities to chart the way forward for tourism in Kenya. Drawing membership from tourism organizations, interested individuals, community groups and suppliers of innovative environmental technologies, the society's main objectives are:

- Fostering tourism practices that conserve Kenya's natural environment and improve the lives of associated communities;
- Developing a framework of environmental management standards for tourist attractions and facilities;
- Devising and publishing eco-tourism regulations and codes of conduct;
- Increasing environmental awareness and consciousness, and developing strategies to mitigate negative ecological, cultural, social and economic impacts of tourism;
- Carrying out research, testing new approaches and initiating and promoting projects related to all aspects of eco-tourism;
- Providing professional advisory and consultancy services in policy, research, planning and management of eco-tourism; and
- Participating in educational and training programmes and developing professional standards, and certifying and rating systems, in all sectors of eco-tourism.

The society has invited local communities interested in showcasing the innovative eco-tourism products they have to offer to use its website free of charge. This is commendable, as it eases one of the main obstacles to community tourism projects, lack of marketing and promotion capacity. The society is in the process of developing a credible, practical, cost-effective and internationally recognized accreditation system (Eco-rating of Kenya's Tourism Product). Targeting hotels, lodges, camps, bush homes and bandas[8], the eco-rating scheme aims at protecting the environment, preventing pollution and minimizing waste, encouraging linkages with local communities, responsible use of scarce resources (land, water, energy, culture, etc.), and educating tourists.

2.2.2.4 Kenya Tourism Federation

This is a private sector umbrella organization established in 1999 to coordinate the activities of the numerous private tourism industry associations. It has a communication centre, which has been instrumental in providing quick information on tourism insecurity incidences and liaising with the security arms of Government for quick response. However, funding has been the stumbling block in its operations and expansion. There is also some degree of duplicity and competition with another organization, Kenya Tourism Concern, which is, however, now increasingly focusing on sex tourism issues.

2.2.2.5 Other organizations

Other tourism industry organizations in Kenya include the Kenya Association of Air Operators, Aero Club of Kenya, Kenya Professional Tour Guides Associations, Kenya Community-Based Tourism Network, and Mombasa and Coast Tourist Association.

2.3 Evolution of tourism policy

Kenya's tourism policy has been characterized by inconsistency, poor coordination, inadequate comprehensiveness, lack of a vision and overall development strategy, and poor implementation (Ikiara, 2001a; 2001b). With the exception of the Sessional Paper No. 8 of 1969 (on development of tourism in Kenya), moreover, the country lacks a specific policy document to date, although the process of developing it is ongoing. Although the sector's performance has been considerably vulnerable to external factors, as the data will show in section 2.4, this poor policy performance played a major role, too. Key episodes of tourism policy development in the country, whose overriding target has always been growth in gross earnings, can be summarized as follows:

- At independence, Kenya started with a very comprehensive tourism policy that can be considered ideal even today (Ikiara, 2001a). It even included principles of sustainable tourism development long before the concept was known as such. A mixture of mass and up-market tourists was the policy focus. These good principles were hardly ever implemented, however.
- Between 1965 and 1994, unfortunately, focus on up-market tourism was lost as the Government emphasized mass tourism by allowing uncontrolled development of tourism facilities. As a result, the role of "package tourism" and "all-inclusive tours" increased over time. Thus, for example, it is estimated that by 1979 about 40 per cent of the tourists came on package arrangements (Kenya, Development Plan, 1980). As data will show in the next

[8] These are traditional huts established in the villages to accommodation tourists/visitors. They are equipped with beds, blankets, bed sheets, clean towels, water and a fire. They are part of eco-tourism programmes aiming at bringing benefits to the people.

section, moreover, this policy led to an increase in tourist arrivals, but a gradual decline in per capita tourist expenditure and average length of stay, among other important parameters. Many authors[9] have attributed the decline in per capita tourist expenditures in the country to the growing role of "package tourism" and "all-inclusive tours".

- Operation of the Domestic Tourism Council between 1984 and 1994 had a considerable impact on the growth of domestic tourism.
- Since the 1990s, there has been considerable public divestiture in the sector, as in other sectors of the economy, although the pace has slowed substantially. This is now set to pick up again following the passing by Parliament of Privatization Bill 2005.
- Between 1994 and 2000, the policy focused on up-market tourists, although no tangible measures were taken towards this end. In 1995, the Kenya Tourism National Master Plan was developed. It made such policy recommendations as diversification of tourism products and source markets, promotion of sustainable tourism, improvement of infrastructure, incorporation of environmental impact assessment studies in tourism development, and the need for zoning in tourism. These policies have, however, also not been implemented consistently.
- Since 2000, policy reverted to the independence period focus on a mixture of mass and up-market tourists, although even during this period, no concrete measures have been taken to reverse the erosion of the country's ability to provide high-value tourist products.
- In 2002, the Government found it necessary to develop an elaborate National Tourism Policy. The draft of this policy has been developed and debated by stakeholders and is now going through the normal formalization process. The draft National Tourism Policy emphasizes several interventions/policies, including promotion of sustainable tourism, review of the existing legal framework to incorporate new policy interventions, and improvement of the institutional framework for the sector.
- In 2003, a Tourist Police Unit (TPU) was established.

2.3.1 Marketing and promotion

Prior to the establishment of the Kenya Tourist Board in 1997, the Ministry of Tourism was in charge of destination marketing, having had nine Kenya Tourist Offices (KTOs) abroad. When the board took over the marketing responsibility, offices were closed and replaced with "public relations marketing consultants". Without performance contracts, these consultants have not done a good job. It has been argued that using foreign offices – which may not necessarily understand the country well or have keen interest with it – at the centre of the marketing effort, is a poor strategy.

Allocation of inadequate resources for marketing has been another major hindrance to tourism marketing and promotion in the country. The opportunity cost of this has recently become evident. A comprehensive joint Government of Kenya–European Union Tourism Market Recovery Programme was established in August 2003, which involved the use of Kshs 500 million for a marketing campaign (mainly through consumer advertising) in 10 European countries over the period January–March 2004. According to data from the Kenya Tourist Board, this campaign had a major impact. Over the period January–June 2004, for instance, tourist arrivals from the source markets targeted by the programme were 17.4 per cent higher over the corresponding period in 2003, while arrivals from the source markets not targeted by the programme declined by 23 per cent. The remarkable performance recorded in 2004, as will become evident in the next section, is largely attributable to this effort.

[9] These include English (1986), Rajotte (1987), Dieke (1991), Sindiga (1999) and Akama (2000).

2.3.2 Foreign participation and trade barriers

Tourism was promoted even before independence to serve the white settlers and visitors from Europe. By independence, therefore, the industry (composed of small family run hotels and beach cottages) was owned by white settlers and later a few Asians. After independence, foreign investment was encouraged through special tax relief on hotel construction. In 1964, the Foreign Investments Protection Act was introduced and recruitment of foreign personnel was encouraged. It was only in the mid 1970s that the Government introduced an upper limit for foreign equity at 49 per cent for lodges in national parks, game reserves and non-hotel tourist service establishments, and foreign exchange control into the tourism sector. In the 1989–1993 Development Plan, the Government introduced measures to control provision of integrated tourism services by tour operators. Both of these restrictions were hardly implemented or sustained, however. With the liberalization measures of the early 1990s and commitments made in GATS in 1994, Kenya's tourism sector is fully open to foreign firms with the exception of restrictions on movement of natural persons and a few other barriers described in section 2.5.

2.3.3 Key policy weaknesses

Key issues that have been ignored by past tourism policies include a shared vision and long-term development strategy, strategies to deal with global competition for tourists, strategies to enhance or augment what nature has provided, inadequate attention to security, failure to embrace emerging technologies, inadequate conceptualization and implementation of the wildlife policy, inadequate support for private reserves, and little use of economic incentives as policy instruments.

2.4 Sector performance and determinants[10]

As a result of the tourism development policies pursued since independence, the Kenyan tourism industry has experienced remarkable growth in terms of tourist arrivals, tourism receipts, bed occupancy rate, length of stay for tourists, domestic tourism and many other indicators. With time, however, the adverse effects of policies such as pursuance of mass tourism, weak economic performance and poor governance that led to near collapse of infrastructure and increased insecurity, and external factors such as increasing competition and terrorism, began to take their toll on the sector. This led to erratic performance, as evidenced by data presented below.

2.4.1 Tourist arrivals

The number of international visitors to Kenya grew from just 73,400 in 1965, at the rate of 7.8 per cent per year, to reach 1,360,700 in 2004 (table 2.1 and figure 2.1). The number of visitors entering the country for tourist reasons also grew impressively. As indicated already, this was largely attributable to the long period the country pursued tourism development policies while most of the other countries in the continent did not.

Table 2.1. Tourism performance indicators, 1965–2004

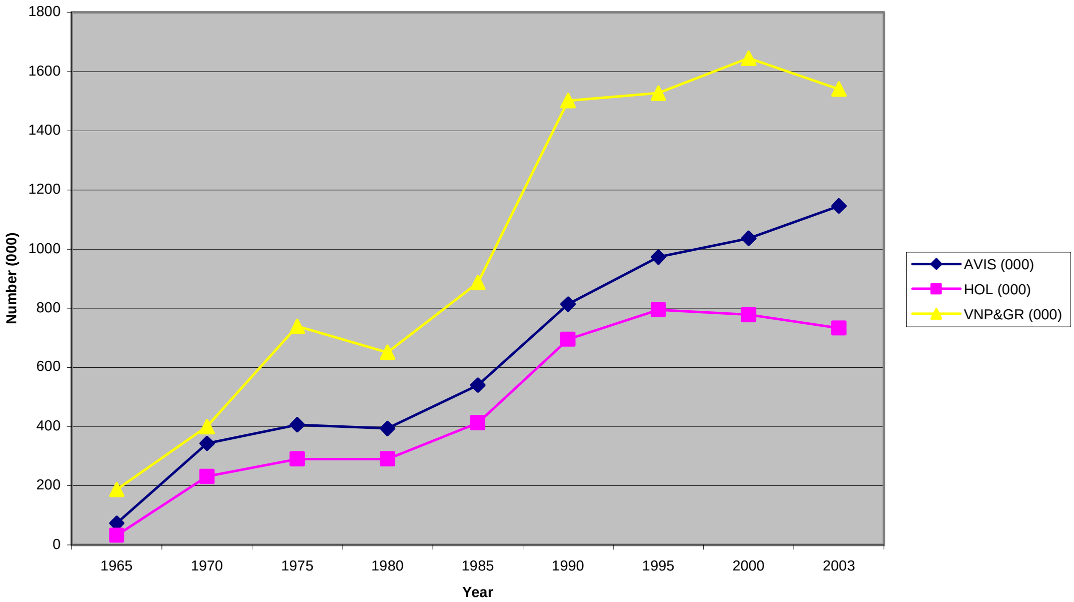
Visitor arrivals	1965	1970	1975	1980	1985	1990	1995	2000	2002	2004*
For holiday (1,000)	32.3	231.7	290.9	290.7	413.2	695.6	795.7	778.2	732.6	885.6
All visitors (1,000)	73.4	343.5	407.0	393.7	540.6	814.4	973.6	1036.5	1001.3	1360.7
Transit (1,000)	30.0	76.3	54.6	53.7	52.3	35.6	55.8	103.5	163.3	162.2
Length of stay (days)	11.1	8.8	12.9	15.7	15.9	14.4	15.2	8.7	8.5	13.0
Hotel bed occupancy rate (%)	47	49	49	57	53	58	43.1	39.3	42.0	37.8

[10] This section borrows heavily from Ikiara (2005).

Visitors to game parks and reserves (1,000)	187.0	400.0	739.0	651.2	886.7	1501.8	1527.5	1644.9	1771.3	1810.7
Visitors to museums, snake parks and historical sites (1,000)	-	282.1	359.2	526.6	705.5	906.9	818.3	885.1	603.1	699.0
International conferences: % occupancy	-	-	-	-	-	-	-	-	3.4	3.8

*** Provisional; Source: Kenya, *Economic surveys* (several issues).**

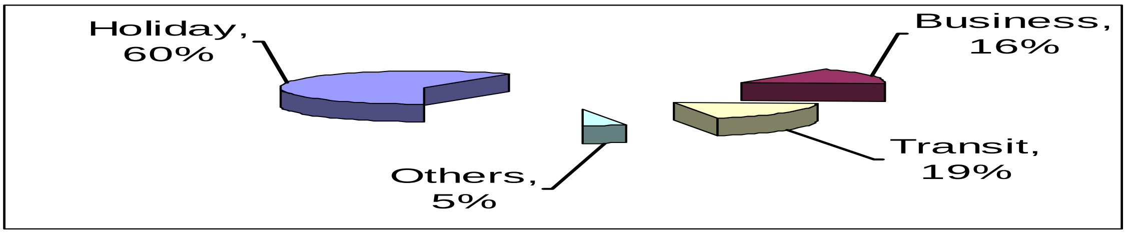
Figure 2.1. Visitor arrivals in Kenya, 1965–2003



Key: HOL= Holiday Visitors; VNPR= Visitors to National Parks and Games Reserves; AVIS = All Visitors

Most of the visitors come into the country on holiday, 60 per cent in 2003, for example (figure 2.2).

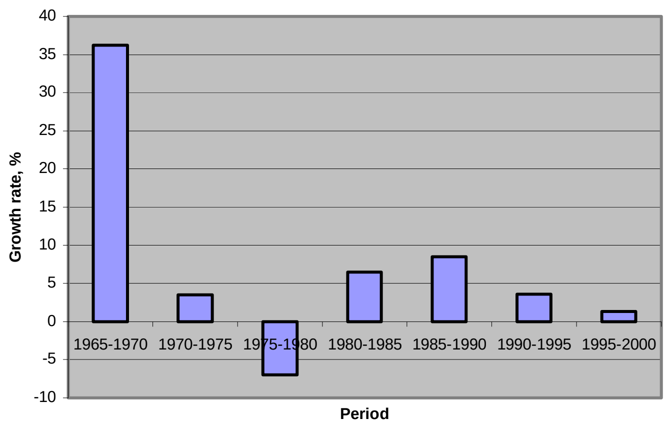
Figure 2.2. Visitor arrivals by purpose of visit, 2003



The growth rate of visitor arrivals varied greatly since independence, being highest in 1965–1970 (36.2 per cent per annum) and lowest in 1975–1980 (figure 2.3). Growth slowed to 3.5 per cent yearly between 1970 and 1975, partly due to insecurity and political instability, and the oil crisis of 1973. The same factors, plus the other oil price crisis in 1979, led to negative growth between 1975 and 1980. Performance since the mid-1990s has been erratic, leading to loss of market share for Kenyan tourism. While the country's share of world international tourist arrivals rose from 0.17 per cent to 0.19 per cent between 1985 and 1990, for instance, it had dropped to 0.12 per cent by 2001.

The growth rate declined to about 3.6 per cent over the period 1990–1995, largely due to political tension triggered by the first multiparty general election in 1992 and the resultant ethnic clashes, the most serious of which was the 1997 Likoni[11] clashes. This decline continued in the period 1995–2000, with the annual growth of visitor arrivals averaging 1.3 per cent per annum. The period since 1995 has been characterized by volatility due to political tensions prior to the 1997 general elections, and the two separate terrorist attacks: (a) against the United States embassy in Nairobi in 1998;[12] and (b) against the Paradise Hotel in the Coast province in 2002. In addition, the September 2001 terrorist attack in the United States affected global air travel and tourism. The situation was aggravated by the persistent adverse travel advisories issued by the country's source countries to their citizens. To date, a travel advisory issued by the United States in 2003 has not been fully lifted and international tourist arrivals have not reached the pre-Likoni levels. Poor infrastructure, worsened by the 1998 *El nino* floods, has also played a part in the poor performance of the Kenyan tourism industry since the mid 1990s. Although not depicted in the figure, the average annual growth rate for the period 2000–2004 averages about 7 per cent. The growth rates depicted in figure 2.3 thus reflect, to a large extent, the phases of overall economic performance discussed in section 1.1.1 of this paper.

Figure 2.3. Growth in international tourist arrivals for Kenya, 1965–2000



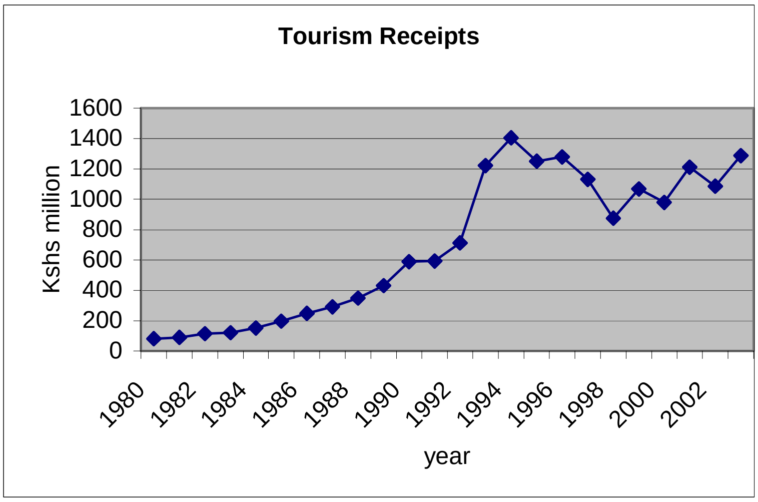
2.4.2 Tourism receipts

Tourism receipts followed a trend similar to that of arrivals, as depicted in figure 2.4, growing at the annual average rate of 23.5 per cent between 1980 and 2003. The highest receipts for the country, until then, were Kshs 28 million received in 1994, after which there was an unprecedented drop of 19.5 per cent between 1995 and 1998 (Ikiara, 2001b). In the 2000s, tourism receipts have recovered remarkably, largely on account of improved image for the country, a marketing campaign in Europe, and strides in improvement of security, especially though the establishment of the

[11] Likoni is in the Coast province, one of the main tourist attractions in the country.
[12] More than 250 people were killed in the attack by the Al Qaeda terrorist group, the worst in the country's history.

Tourist Police Unit, among other factors. In 2004, for example, the receipts increased by 51.9 per cent to reach Kshs 39.2 billion.[13]

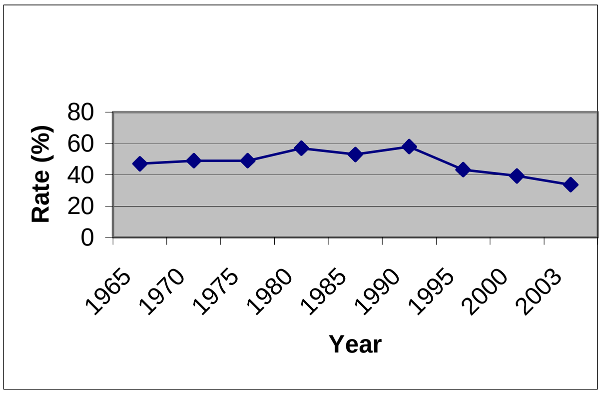
Figure 2.4. Tourism receipts for Kenya, 1980–2003



2.4.3 Hotel bed occupancy

Hotel bed occupancy rate followed a similar pattern, in general, although a persistent decline occurred from the early 1990s (Fig. 2.5). With occupancy rates so low, there has been cutthroat competition in the hotel industry, with some offering extremely low accommodation rates. This has not only led to considerable decline in service quality, but also to the closure of some of the hotels. The year 2004 saw a rebound in hotel occupancy, however, rising to 37.8 per cent from 33.6 per cent in 2003. The boom was expected to continue in 2005. It is feared that the Government may approve new accommodation investments in already over-developed locations because of this performance, rather than using the opportunity to initiate the gradual switch towards the high-value tourism market segment.

Figure 2.5. Hotel bed occupancy rates, 1965–2003

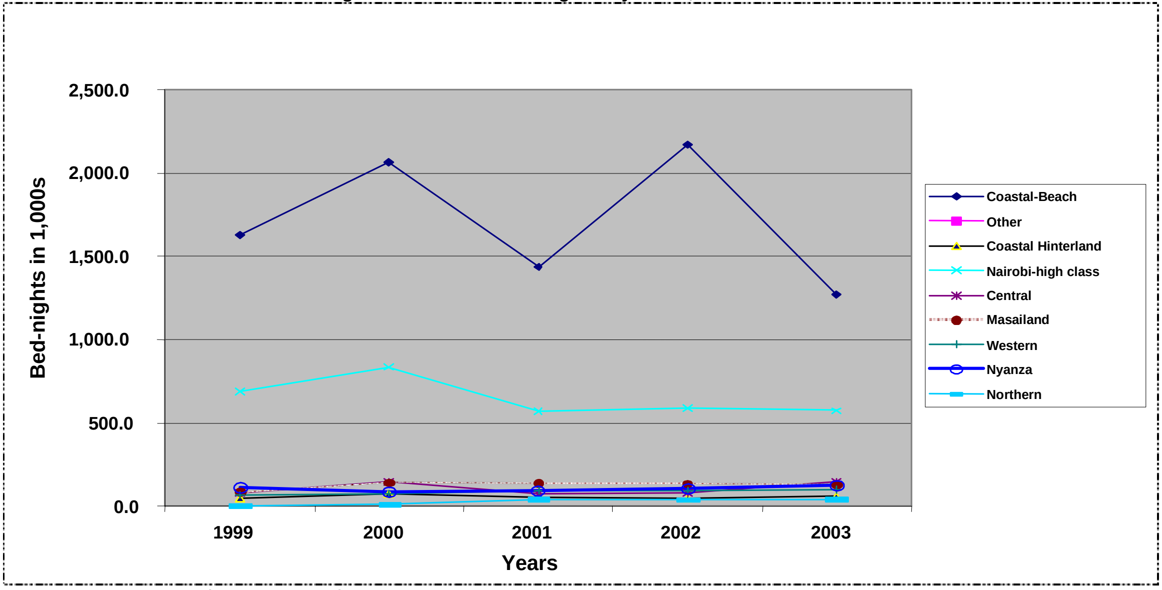


Bed-nights are concentrated mainly in the coastal beaches and Nairobi, although they have tended to fluctuate considerably in coastal beaches (figure 2.6). In 2004, coastal beaches alone accounted

[13] Kenya (2005), *Economic Survey 2005*.

for 49.7 per cent of total bed occupancy, while the Coast and Nairobi provinces jointly accounted for 77.9 per cent (Kenya, 2005).

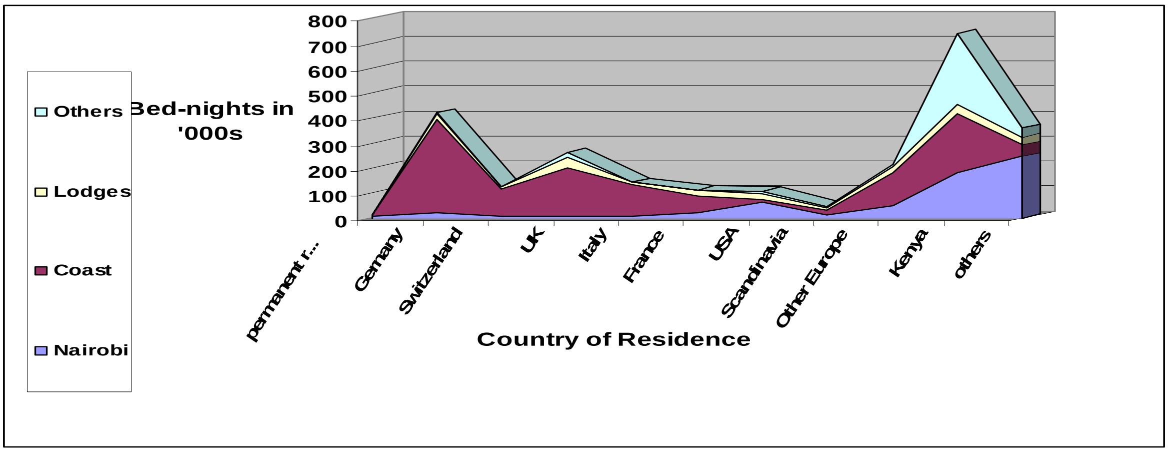
Figure 2.6. Hotel bed-nights by zone, 1999–2003



Data source: Economic Survey, various years.

Tourist source markets for Kenya differ in their preferences, as indicated by the relative number of bed-nights (figure 2.7). German tourists, for example, have strong preference for the coastal beaches compared with the United States tourists, who appear to have more bed-nights in Nairobi.

Figure 2.7. Bed-nights (in thousands) by area and country of residence, 2003

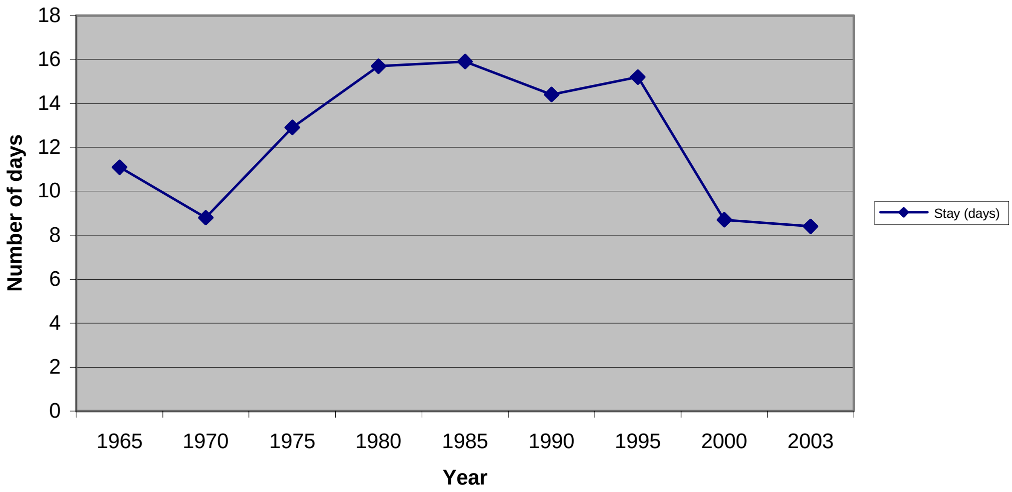


Data Source: Economic Survey, various years.

2.4.4 Length of stay

The average length of stay increased by about 1.8 per cent annually between 1965 and 1985, to peak at 15.9 days in 1985. From 1985 to 2003, however, the length of stay declined at the rate of 7.7 per cent per year, to reach 8.4 days in 2003 (figure 2.8). In 2004, there was a dramatic rise to 13 days.

Figure 2.8. Average length of stay (days), 1965–2003

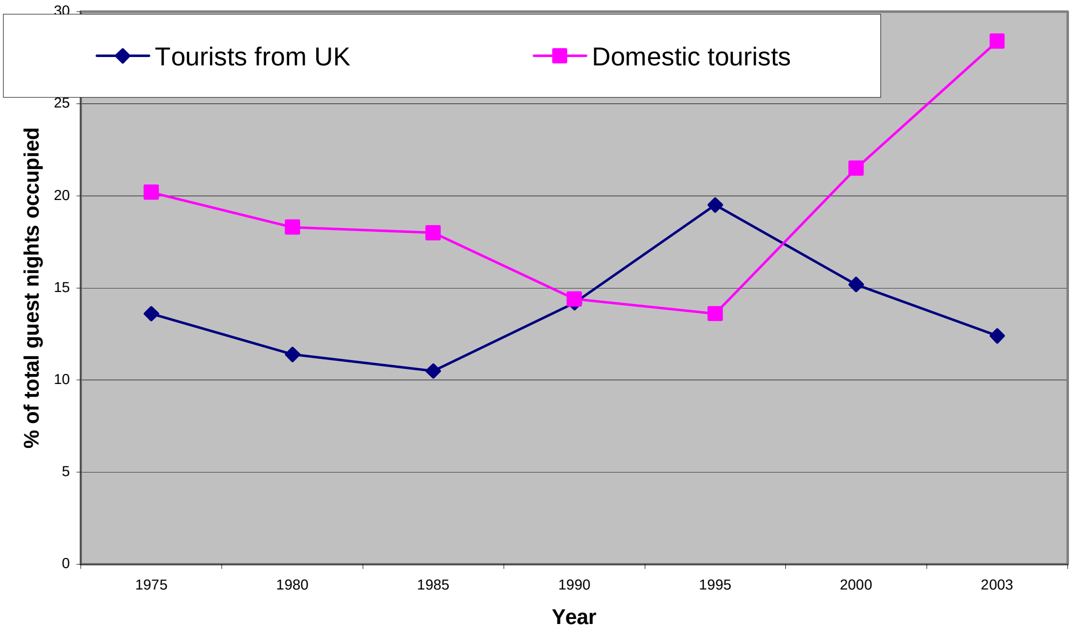


2.4.5 Domestic tourism

An important feature of Kenya's tourism is its heavy reliance on international tourism as opposed to domestic tourism. Indeed, the tourism infrastructure and service is generally aligned to the European market and is not sufficiently attractive to domestic tourists who find even the food "foreign". For example, the proportion of guest nights occupied by domestic tourists dropped from 20.2 per cent in 1975 to about 13.6 per cent in 1995 (figure 2.9). Because of policies pursued to promote domestic tourism for many years, however, the share picked up, to reach 28.4 per cent by 2003 and 31.4 per cent in 2004. In fact, during public holidays such as Easter, domestic tourists account for up to 70 per cent of all bed-nights occupied.

The Ministry of Tourism and Wildlife, together with industry stakeholders developed a domestic tourism policy in 1984, as part of which a Domestic Tourism Council was created the same year. Drawing membership from the public and private sectors, and with its secretariat located in the ministry headquarters, the council was mandated to promote local tourism. It did this through reduction of hotel and transport rates during the low season, collaboration with and coordination of stakeholders, reduction of entrance fees to national parks and game reserves, introduction of incentive holidays, provision of tourism information by all stakeholders, publishing of a magazine on domestic tourism and mounting of other media campaigns to promote domestic tourism, and provision of information about domestic tourism to the youth through the wildlife clubs and schools of Kenya.

Figure 2.9. Guest nights in Kenya by domestic tourists, % of total, 1975–2003.



Source: Ikiara (2005).

The council was transformed into the Kenya International Tourist Exhibition as a means of simultaneously promoting international, regional and domestic tourism.[14] The last exhibition was held in 1997. Since then, however, tourist circuits have been re-launched in the North Rift, Mount Kenya, and Nairobi, and exhibitions have been made at Agricultural Society of Kenya shows and other local forums. There is a strong case for re-establishing the council and building its capacity, owing to the importance and huge potential of domestic tourism in the country.

2.4.6 Regional tourism

Kenya's tourism is heavily dependent on the European Union, with the region continuing to account for about 60 per cent of annual tourist arrivals for the country (table 2.2). Even within Europe, two countries (Germany and the United Kingdom) generate the bulk of the country's tourists.

Table 2.2. Visitor departures from Kenya by country of residence (1,000), 1980–2004

Country of residence	1980	1985	1990	1995	2000	2002	2004*
West Germany	76.2	100.3	133.4	97.8	206.3	258.4	172.3
United Kingdom	49.9	65.5	108.8	96.3	148.2	211.8	298.1
Switzerland	27.3	44.6	33.3	22.3	25.9	78.2	61.8
Italy	21.6	34.2	36.3	40.8	30.3	75.9	129.5
France	15.6	24.6	40.3	36.7	24.7	59.0	85.5
Scandinavia	-	13.4	18.9	19.3	21.0	20.2	40.3
Other Europe	36.6	35.8	51.1	39.7	166.3	80.87	142.5
Total Europe	**227.2**	**318.5**	**422.1**	**352.9**	**622.7**	**791.2**	**930.0**
United States	30.8	54.3	43.3	44.7	54.0	61.7	109.6
Canada	5.0	7.6	10.3	9.4	18.3	8.0	29.5
Total North America	**35.8**	**16.9**	**53.6**	**54.1**	**72.3**	**69.7**	**139.1**

[14] Personal communication with Mr. Okungu, a retired senior officer at the Ministry of Tourism and Wildlife.

United Republic of Tanzania	3.5	22.1	73.1	76.8	42.6	9.1	19.8
Uganda	10.4	24.8	21.4	51.7	39.9	9.2	18.3
Total Africa	64.6	113.8	193.5	189.0	145.1	69.2	87.0
Asia	27.1	39.3	39.4	40.8	55.6	44.7	77.6
Australia and New Zealand	4.4	3.7	9.7	8.8	17.3	7.8	14.2
All other countries	7.9	4.0	2.5	2.9	59.7	9.1	11.9
Total	**362.6**	**541.2**	**720.8**	**648.5**	**972.7**	**991.7**	**1259.8**

*** Provisional**

Source: Kenya, *Economic Survey* (various issues).

Regional tourism, especially from East Africa in general and the United Republic of Tanzania in particular, increased impressively between 1980 and 1995, before decreasing considerably by 2002. East Africa's share of visitors departing from the country rose from 3.8 per cent in 1980 to 19.8 per cent in 1995, before falling to 1.8 per cent in 2002 (table 2.2). This share rose marginally to about 3 per cent in 2004. Tourists from the region, moreover (along with the rest of the world) increased their average length of stay in Kenya between 1985 and 2002 (table 2.3). The decline in the tourist length of stay in the Kenyan tourism industry in the last decade or so was greatest with respect to European and North American tourists.

Table 2.3. Average length of stay (days) by region, 1975–2002

Region	1975	1980	1985	1991	1995	2000	2002	Change, 1985–2002
United Kingdom	17.1	19.7	20.4	15.6	9.6	8.5	8.7	-11.7
West Germany	14.5	17.0	16.0	16.5	14.6	8.6	8.8	-7.2
Other Europe	13.1	14.4	25.7	13.0	9.9	6.4	6.6	-19.1
North America	13.7	16.5	16.2	13.3	7.1	8.7	8.9	-7.3
Asia	14.2	16.8	14.8	14.3	6.2	11.8	11.9	-2.9
East Africa	10.1	16.3	7.9	9.7	5.6	8.5	8.7	+0.8
Other Africa	9.9	11.1	9.8	12.8	6.0	9.0	9.2	-0.6
Rest of world	12.5	16.1	12.1	13.3	10.1	18.4	18.8	+6.7

Source: Kenya, *Statistical Abstract*, various issues.

Related to this, and more significantly, tourists from Europe are reportedly spending far much less in Kenya than those from Africa. In a recent article,[15] data attributed to the Kenya Tourist Board showed that while the per capita expenditure by overseas tourists in Kenya averages $700 for a week, that by an African tourist for the same period averages $1,500. With the re-establishment of the East African Community in 2000 and the expected simplification of cross-border movement of factors of production, and the improvement of air transport services in the region, regional tourism is expected to become even more important for Kenya. The plans being considered to promote the region jointly and establish regional tourism circuits will not only lead to further growth of intraregional tourism, but also attract more international tourists to the region.

2.4.7 Relative performance

Kenya is very well known by the customers relative to such competitor destinations as the United Republic of Tanzania, Zimbabwe and Botswana (table 2.4) due to its long experience with tourism. However, the country performs much more poorly than its competitors with respect to destination appeal, quality of the safari product, and the overall quality of the tourist experience.

[15] Kariuki J (2005). Unsung value of African tourists: they spend more in Kenya than the more hyped visitors from Europe. *Sunday Nation*. 9 January:10.

Table 2.4. Relative competitiveness and appeal of Kenya and other selected destinations[16]

Parameter rated	Kenya	United Rep. of Tanzania	Zimbabwe	Botswana	South Africa
Customer awareness of destination	**84.5**	43.2	64.3	46.4	90.0
Destination appeal	**63.6**	72.1	70.8	77.5	90.0
Quality of the safari product	**77.8**	68.9	88.1	100.0	92.6
Value for money	**62.2**	36.4	57.1	58.6	70.0
Overall quality of tourist experience	**77.3**	63.7	83.3	92.9	92.7

Source: **Compiled from various tables in TTC (1999).**

Consultations with industry players indicate that the country has several strengths over some of its competitors, including good relationships with overseas agents, the wide variety of products available in the country, its magnificent scenery and good climate, hospitality of the people, a long span of political stability, professionalism in the industry coupled with good interaction with customers, and availability of relatively cheap labour that can be hired in the high season. High food and service quality in lodges is cited as another source of attractiveness for Kenyan tourism. Relative to competitors, however, the country is weak in the areas of planning, management of wildlife parks and other tourism resources, diversity and quality of infrastructure, marketing effort and resources, innovativeness of product packaging and marketing, security, higher taxes, lack of capital and less support from the Government.

2.4.8 Factors responsible for tourism performance: a SWOT analysis

The data presented in the preceding sections has shown that, although there were periods of low and even negative growth, tourism in Kenya performed remarkably well from the 1960s, reaching a peak around 1994. Thereafter, the sector was characterized by unprecedented erratic performance with the period 1995–1999 experiencing unprecedented decline.

2.4.8.1 Overview

The remarkable growth for most of the post-independence period is attributable to (a) four decades of relative political and economic stability; (b) relatively well-developed infrastructure for most of the period before 1990s; and (c) a liberal investment climate, even for foreign investment. A well-established tourism infrastructure therefore characterizes Kenya as a destination. As tourism has grown over the decades since independence, moreover, public and private sector institutions and businesses have been developed. These have accumulated considerable experience, giving the country a competitive edge over some of its neighbouring competitors. Kenya is now a mature market.

The country has a long history of a favourable policy environment for private investment, including largely unrestricted entry of foreign investors in most of the services sectors, national treatment and non-discriminatory policies, free repatriation of profits, a relatively generous issuance of work permits and in many cases preference of foreign service suppliers over local competitors. The liberal policy was strengthened by the commitment of tourism services under GATS in 1994.

The dismal performance recorded in the 1970s was partly attributable to insecurity and political instability, including the tensions with the United Republic of Tanzania, the eventual collapse of the East African Community in 1977, and the 1973 and 1979 oil crises. The period between 1995 and

[16] Figures in the table indicate the percentage of tour operators in the United Kingdom, United States and Germany (out of a sample of 46 of tour operators selling East and Southern Africa tourist products) rating the given parameter for the given country as "good" or "excellent".

2003 was characterized by unprecedented decline and erratic performance on account of myriad internal and external problems:

- The political tension triggered by the first multiparty general election in 1992 and the resultant ethnic clashes, the most serious of which were the 1997 Likoni clashes;
- The perceptions of insecurity following terrorist attacks in Nairobi (in 1998) and the Paradise Hotel in Mombasa (in 2002); and
- The September 2001 terrorist attack in the United States, which is estimated to have caused a 16.1 per cent decline in the real growth of travel and tourism demand for two years (-10.2 per cent in 2001 and -5.8 per cent in 2002) in Kenya.[17] The situation was not helped by the persistent adverse travel advisories issued by the United States and some European countries. A travel advisory issued by the United States in 2003 has to date not been fully lifted.

Other factors that adversely affected tourism performance in the country include poor infrastructure, competition from emergent destinations such as South Africa and the United Republic of Tanzania, rising cost of air travel and other services, poor government policies – especially concerning promotion of mass tourism – and lack of a vision and long-term development strategy shared by all stakeholders. The pursuance of the mass tourism market for a long time, especially between 1965 and 1994, has led to the country being perceived as a "mass market" destination. The expansionary and mass-market policy eventually destroyed the country's unique attractions that suited high-value tourism, due to overcrowding, environmental destruction and a general strain on resources. Key attractions such as the Mara, the Amboseli and marine resources are under tremendous environmental pressure. The main internal factors that shape Kenya's tourism therefore include security, infrastructure, marketing/promotion efforts, and general economic management. Recent research[18] suggests that, *ceteris paribus*, a 1 per cent:

- Increase in the number of reported robberies (measure of insecurity) could reduce tourism receipts by 0.7 per cent;
- Increase in the length of all-weather roads could yield about a 6 per cent increase in tourism receipts (Availability, capacity, efficiency and high cost of other infrastructure such as telecommunications and electricity are also important hindrances.);
- Increase in public expenditure on overseas tourism marketing could lead to a 0.38 per cent overall increase in tourism revenue; and
- Appreciation of the Kenyan shilling could lead to a 0.73 per cent fall in tourism revenue.

Other important internal factors include (a) high taxes; (b) poor tax administration; (c) poor governance, including unfair competition from unlicensed operators; (d) lack of access to affordable finance; (e) high cost of air, road and other transportation; (f) high fuel costs; (g) inadequate domestic management and entrepreneurship capacity, including inadequate supply of well-trained people; (h) poor planning, including lack of harmonization of wildlife, tourism and land use policies, and weak spatial dispersion of tourism; and (i) a policy, legal and regulatory framework that impedes tourism development, including lack of a tourism policy and strategic plan to implement it,

[17] WTTC (2002).
[18] Ikiara et al. (2003).

inappropriate laws, lack of regulatory frameworks for some industry segments, and failure of the two main pieces of tourism legislation to provide for environmental conservation[19].

On the other hand, the main external factors that constrain Kenya's tourism sector include intensifying global competition for tourists, fluctuations in the economic performance of leading tourist-generating countries[20], increasing cost of air travel, global insecurity from terrorism, the war in Iraq, severe acute respiratory syndrome (SARS), the exchange rate, market access and national treatment restrictions in developed countries, and inadequate liberalization of air transport services.

2.4.8.2 Hotels

Hotel and lodge facilities interviewed in 2003 from Nairobi, Mombasa, Nakuru and Kisumu cited many factors that constrain their service supply capacity and recent interviews confirmed the results of the 2003 study. These include high tax rates and poor tax administration, macroeconomic instability and policy uncertainty, and problems with telecommunications, electricity, and transportation (Table 2.5).

Table 2.5. Constraints faced by hotels in Kenya, 2003

Constraint	% of firms citing it as major or very severe obstacle
Telecommunications	20.5
Electricity	29.4
Transportation	26.5
Tax rates	63.6
Tax administration	31.3
Access to finance, e.g. collateral	25.8
Economic and regulatory policy uncertainty	35.5
Macroeconomic instability (inflation, exchange rates)	44.1
Crime, theft, disorder	47.0
Anti-competitive or informal practices	27.5

***Source:* World Bank/KIPPRA RPED survey 2003.**

About 49 per cent of the hotels cited inadequate supply of infrastructure among the three biggest obstacles to doing business in the country. Close to 50 per cent of the hotels, moreover, felt that crime, theft and disorder (or insecurity in general) were major or very severe obstacles. According to the Kenya Association of Hotel Keepers and Caterers, moreover, the poor perception of the country in overseas markets is the most constraining factor for the hotel industry and the tourism sector as a whole. In addition, the industry would like effective involvement of the private sector in the classification of hotels, determination of further accommodation investments needs and determination of the appropriate location of that investment.

2.4.8.3 Tour operators and travel agents

The tour operators and travel agents interviewed recently (Ikiara, 2005) identified various constraints to their domestic supply capacity, including poor roads, insecurity, harassment of tourists at the beaches, high cost of air transport services, high cost and low capacity of telecommunications that affect connectivity and speed of accessing databases, inadequate marketing of tourism products in the country, high taxes, high fuel costs, high prevalence of

[19] The draft tourism policy and the Environmental Management and Coordination Act (1999), however, make provisions for environmental protection.

[20] Recent research by Ikiara et al. (2003) suggests, for instance, that a 1 per cent increase in real GDP growth rate in the tourist source countries has a 0.13 per cent increase in tourism receipts for Kenya.

unlicensed and non-International Air Transport Association “briefcase” operators which affects service quality, not enough well-trained people, and the generally poor state of the economy.

The main constraint facing travel agencies currently, however, is the low margins they get and the threat hanging over the commissions they get from selling tickets on behalf of the airlines. Consultations indicated that travel agencies are operating on very poor commercial terms, that is, only 0.25 per cent net profit. This is largely blamed on the decision by Kenya Airways to reduce the commission it pays to the travel agencies from 9 per cent of the value of ticket sales to 8 per cent and then to 6 per cent in the last two to three years. The airline has the policy of gradually operating on a zero commission policy, implying that travel agencies will be forced to charge clients management or other fees. While some big travel agencies can cope with this, the many indigenous travel agencies are not prepared.

The decision by the Kenya Airways, which has been adopted by some international airlines, is costing the country in terms of foregone tax and other income. Firstly, travel agencies prefer to sell foreign carrier tickets especially for carriers paying a 9 per cent commission. This reduces the business available to the local airline thereby increasing leakage. Secondly, by receiving a 6 per cent (as opposed to 9 per cent) commission, the travel agencies receive less revenue and the country less tax. There are several reasons why travel agents merit assistance. Firstly, travel agencies, most of which are locally owned, are an important subsector to promote the local and SME presence in the tourism industry. Secondly, despite technological progress, travel agencies will continue to play an important role in a country such as Kenya, where telecommunications and other infrastructure problems are serious. Thirdly, the law in the country protects the insurance brokerage commission of 10 per cent, implying that there is no reason why the same cannot be done for travel agency commissions. Fourthly, travel agency commissions are protected in such countries as Mauritius and Rwanda, a protection the Kenyan travel agency industry seeks. Finally, they are already making preparations for the zero commission regimes.

2.4.8.4 Air transport

Air transport services are critical to the performance of tourism in Kenya, as more than 50 per cent[21] of the arrivals are by air. There are bottlenecks with this service, however, including the following:

- Capacity problems associated with the high cost of aircrafts and fuel, low usage of ICTs, and management weaknesses. Finance for aircraft acquisition can enable locals to participate in the business. There is also a problem with the quantity and quality of infrastructure such as airports and air navigation facilities. Facilities such as more international airports, surface transport connecting the airports and major urban centres, and an airport hotel are required. Since Kenyan airports can hardly meet International Civil Aviation Organization (ICAO) standards, the country’s carriers are not allowed to fly to the United States.
- There is an additional capacity problem associated with inadequacy of trained human resources, especially in aviation. The East African School of Aviation could be supported to address this problem.
- There is an inadequate supply of scheduled services.

[21] This was in fact 63 per cent in 1995 and 2000.

2.4.8.5 SWOT: Summary of determinants of tourism performance in Kenya

In summary, except for the rich endowment in the inherited (natural and cultural) resources, the other bases for destination competitiveness are weak or totally lacking in Kenya. The created resources (including tourism infrastructure, special events, range of available activities, entertainment and shopping) and the supporting factors and resources (general infrastructure, quality of service, and accessibility of the destination) are generally poor. The country, moreover, has not been innovative enough in developing its flagship or brand products or even improving the products in tandem with changes in consumer tastes and preferences. Table 2.6 summarizes these factors within a strengths, weaknesses, opportunities and threats (SWOT) framework.

Table 2.6. SWOT analysis of the Kenyan tourism sector

Strengths	**Opportunities**
• Rich natural, physical and cultural resources, and the wide variety of products available, including the magnificent scenery and good climate; • Long experience with tourism leading to well-established infrastructure, and high food and service quality; • Competitive and well developed industry; • A city which is a regional air transport hub, has a national park, and hosts two United Nations organizations; • Warm, friendly and hospitable people, most of whom speak English and Swahili; • Preparation of national tourism policy at an advanced stage; • Good relationship with market agents in Europe and United States, to some extent, thus high customer awareness of country; • Establishment of Tourist Police Unit; • Long span of political stability; and • Relatively cheap labour that can be hired in the high season.	• Emergence of new markets, especially in Eastern Europe and Asia; • Availability of development assistance, for example, from the European Union; • Granting of the country Approved Destination Status by China; • Improved international image of country after 2002 elections, although allegations of corruption are reversing these gains; • Multilateral and other trade negotiations such as GATS and ACP–EU economic partnership agreement frameworks; and • Movement towards peace after many years of conflict and war in neighbouring countries, such as Somalia and Sudan.
Weaknesses	**Threats**
• Negative perception of the country with respect to insecurity, political uncertainty including ethnic clashes around election periods, crumbling infrastructure, mass tourism, harassment by beach boys, chaotic public transport; • Perception of low value for money, partly due to poor development of created resources such as special events, range of activities, entertainment and shopping; • Overdevelopment of facilities in some areas such as the Coast, while many other areas are underdeveloped – in general, poor planning and lack of land use policy; • Overreliance on Europe as a source market; • Considerable legal and regulatory constraints; • Lack of adequate resources for marketing and a poor marketing strategy that fails to place Kenyans who care more about their country at the centre of the marketing efforts; • Highly seasonal nature; • Considerable leakage of tourism revenue; • High taxes and cumbersome tax administration; • Poor quality and high cost of telecommunications; • Lack of highly trained personnel; • Policy and regulatory uncertainty and generally poor economic management and performance; • Capital constraints; • Inadequate support by the Government; • Low innovativeness with respect to development of flagship or brand products; and • Lack of a system to ensure equitable sharing of benefits and opportunities of tourism with local communities.	• Fluctuations in the economic performance of leading tourist-generating countries; • Worsening global insecurity from terrorism; • Increasing competition from alternative destinations; • Travel advisories and other trade barriers in Europe and the United States; • High and increasing cost of air transport services; and • Inadequate supply of scheduled air transport services.

Source: **Ikiara (2005).**

2.5 Impact of Kenya's GATS commitments in tourism

As shown in Kenya's GATS schedule of specific commitments of 15 April 1994 (table 2.7), the country has committed to all the tourism and travel-related services: hotels and restaurants (including catering services), travel agencies and tours operators, and tourist guide services. There are hardly any significant barriers, regardless of mode of supply, to foreign supply of tourism services in the country. The only limitations are with respect to Mode 4 on movement of natural persons (all tourism services) and Mode 1 (hotels, restaurants and catering services).

Table 2.7. Kenya's schedule of GATS commitments in tourism and travel related services
Mode of supply: 1) Cross-border supply; 2) Consumption abroad; 3) Commercial presence; 4) Presence of natural persons

Sector or subsector	Limitations on market access	Limitations on national treatment	Additional Commitments
Horizontal Commitments			
Tourism And Travel Related services. A. Hotels and restaurants (Including catering services)	1) Unbound* 2) None 3) None 4) Unbound except as indicated in the horizontal section	1) Unbound* 2) None 3) None 4) None, for the categories of persons referred to in the market access column of the horizontal section	
B. Travel agencies and tour operators services	1) None 2) None 3) None 4) Unbound except as indicated in the horizontal section	1) None 2) None 3) None 4) None, for the categories of persons referred to in the market access column of the horizontal section	
C. Tourist guide Service	1) None 2) None 3) None 4) Unbound except as indicated in the horizontal section	1) None 2) None 3) None 4) None, for the categories of persons referred to in the market access column of the horizontal section	

***Source:* WTO website.**

Being desirous of attracting more investment in tourism, Kenya does not have restrictions on any of the following: equity holdings, form of doing business, and limitation on purchase and size limitations for establishments. It also does not have unspecified economic needs tests. In fact, the Government offers some investment incentives such as import duty waiver on hotel construction equipment, profit repatriation and tax holidays. The extent of liberalization of the sector is evident from the fact that, within the ongoing GATS 2000 negotiations, only the United States has requested Kenya to make further commitments in the sector.

2.5.1 Some requirements and barriers

A closer examination, however, through the openness index of the WTTC, suggests that Kenya's tourism is not as open as one would expect from its schedule of commitments, or in comparison with the Eastern and Southern Africa (ESA) region. While the index for Kenya stands at 25.63, those of Seychelles, South Africa, Eritrea, Malawi, Mauritius, Egypt and the ESA region as a whole stand at, respectively, 82.0, 72.45, 72.43, 62.17, 55.87, 44.09, and 33.39 (Ikiara, 2005).

2.5.1.1 Unspecified approval and license requirements

There exists some unspecified license requirements in Kenya's tourism industry. In the case of licensing of hotels and hotel managers, for example, the requirement for menu and manager's qualifications, respectively, are not spelt out in the law. The HRA Act empowers the licensing authority to introduce such requirements if they can help in improving the standards.

2.5.1.2 Restrictions on mobility of key personnel

Under normal circumstances, a foreign firm established in Kenya is allowed one key personnel after an economic needs test is conducted to ascertain that the person has unique skills or is representing the interests of the investor. There are cases, however, where foreign investors apply for work permits for close relatives over and above key personnel. The work permits committee of the Ministry of Tourism and Wildlife has discretionary powers to make recommendations on such applications to the immigration work permit committee, which has final authority. In the case of intra-corporate transfers, the applicant must have worked with the parent company for not less than two years.

Even though there is a safeguard in the form of economic needs tests, corruption and dishonesty make the process vulnerable. Thus, for example, more than 50 per cent of the work permit applications for tourist guides are under intra-corporate transfers. The applicants often claim to be tour leaders with special foreign linguistic skills, while others claim to represent investor interests. The ministry lacks capacity to verify such claims.

2.5.2 Impact of the commitments

What has been the impact of the tourism commitments Kenya has made on the industry's performance? There is no study that has attempted to isolate the impact of Kenya's GATS commitments on tourism industry performance. However, from industry consultations there has been no obvious impact. The main reason for this is perhaps that the industry was already largely liberalized even before the commitments were made. Another possible explanation is that, since the investment or business climate in the country was not attractive for most of the time since the mid-1990s when the commitments were made, foreign investors have been reluctant to take advantage of the policy certainty introduced by the GATS commitments. Of great concern, though, is the implication of committing tourist guide services. It means that foreign tour guides, some of whom have little or no knowledge of the country, can come in and seek work permits to offer this service. This can lead to not only a deterioration in tour guide service provision, but also allow competition from foreigners for a service Kenyans have the capacity to supply.

2.5.2.1 Foreign presence

The many years of favourable policy environment for foreign investors are evidenced by the strong foreign presence in the sector (Ikiara 2001b). About 80 per cent of all tourists who visited Kenya in 1993–1994 were attributable to foreign tour operators; a significant share of the major hotels at the coast and in Nairobi, national parks and reserves have some foreign investment, although less than 20 per cent of them are entirely foreign owned. Data on the actual magnitude of foreign participation in various segments of the Kenyan tourism industry is, however, unavailable.

2.5.2.2 Degree of competition

In general, the degree of competition in the various segments of Kenya's tourism industry is high. Indeed, in some segments such as hotels there is high competition leading to very low margins. There is also competition from informal unlicensed operators, especially in tour operation and travel agency. In air transport, the partnership between Kenya Airways and KLM has reduced competition in the region, which could become a significant threat to tourism in the country.

2.5.2.3 Role of e-commerce

According to the Kenya Tourist Board (KTB), the Internet is one of the greatest resources for the tourism industry (KTB, 2003). Thus, for instance, within three months of the launch of magicalkenya.com, the website already judged as Africa's best and largest single destination website[22], 2,000 individuals visited the site on a daily basis and a poll of visitors indicated that 6 per cent of them had used the site to plan their trip. The advantages Kenya has with respect to exploiting the opportunities offered by the Internet include (a) high and increasing access to the Internet and high ICT awareness, mainly attributable to intensive competition among the many Internet Service Providers, which has improved service and reduced price substantially; and (b) one of the highest computer training and literacy rates on the continent (KTB, 2003). The country's telecommunications infrastructure, however, has to be developed further to support bandwidth and connectivity. In the African IT Forum held in Berlin in 2003, WTO projected that no tourist player who was not doing business online would survive five years, and noted that the developing world required national and regional portals to achieve online market presence.

This method has advantages such as providing access to a world of business without borders, facilitating direct contact with the client, and convenience, as all the services including bookings are covered, and ease of access worldwide, especially because of steadily decreasing costs of hardware and increasing availability of software. Direct access to tourists through the Internet has the additional advantage of guaranteeing the highest markup for local operators, and having direct and firsthand contact and feedback from the client.

Accessing tourists through the Internet has weaknesses too, however, including increased competition through ease of copying products and services displayed in websites, payment problems associated with slow procedures and insecurity (frequent cases of fraud), and high cost of maintenance and frequent updating. The cost of embracing new technologies is high, as is that of keeping abreast with the rapidly changing technology. This requires not only the purchase and installation of hardware and software, but also training of personnel, implementation of systems, and upgrading of the required physical infrastructure. The method of accessing tourists directly is associated with very high distribution costs, especially with respect to initial costs.

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[22] This has been so judged by such international companies as IBM, CNN, and PC World Magazine.

2.5.2.4 High cost of making a mistake

The process of reversing commitments already made within GATS is time-consuming, costly and difficult. It would require renegotiations that could take at least 90 days and commitment of other services as compensation for the reversal. This high cost of making a mistake has made the Government and the private sector hesitant to make new commitments without thorough analysis of the likely implications.

2.6 Barriers to Kenya's trade in tourism services

As indicated earlier, Europe has been and continues to be the main market for Kenya's tourism. Africa, the United States, Asia and domestic tourism are, however, becoming increasingly important. There are considerable barriers or obstacles to the country's tourism exports, including high leakage of earnings, competition from giant integrated suppliers in developed countries, access to Global Distribution Systems (GDS)/Computerized Reservation Systems (CRS), travel advisories, access to ancillary services to air transport and security measures, and other trade barriers.

2.6.1 Leakage

Through its relatively high multiplier effect, tourism has stimulated the development of other economic sectors in the country. Thus, agriculture, transport, manufacturing, building and construction, and curio industry, among others, have been stimulated by tourism growth. Testimony to this is the relatively reasonable level of leakage of tourism revenue from the country. Tourism earnings leak out through imports of goods and services consumed by tourists, salaries for expatriate employees, repatriation of profits, and transport services offered by foreign suppliers. The import content of Kenya's tourism industry is relatively low, ranging from 23 per cent to 27 per cent (English, 1986; Christie and Crompton, 2001)[23] compared with 35–50 per cent for some island economies. Nevertheless, TTC (1998) estimates that for every Kshs1 worth of imports substituted in the Kenyan tourism industry, an additional 98 jobs would be created in the modern sector and Kshs 646,000 government revenue would be generated, which would be a key contribution to sustainable tourism development.

TTC (1998) estimates the import content of goods and services in the Kenyan tourism industry as follows:

- 24 per cent of the total costs incurred in hotel rooms (including linen, laundry and maintenance);
- 26 per cent of food costs (principally poultry, meat and fruits); and
- 40 per cent of the total beverage costs in hotels (55 per cent of wine costs and 41 per cent of costs of spirits).

Sinclair (1990) found that the Kenyan economy retained 22–88 per cent of the foreign exchange accruing from tourism, depending on the type of holiday, the season, and the provider of the flight service (Ikiara, 2001b). He found that the factors that promote tourism revenue retention include long holidays, high season visits, provision of air travel services by the destination carrier, and safari tourists as opposed to purely beach holidays. Sinclair (1992) also found that foreign tour operators could negotiate hotel room rates that were as low as 50 per cent of the rates charged

[23] Some sources (such as Akama, 1999), however, estimate that up to two thirds of the gross revenues go to foreign-owned tour operators and airlines, as well as paying for imports.

individual clients. There is need for a study to establish the share of value added from tourism activities that is retained in the country, as existing studies are too dated and partial, and vary widely in the results. There is an ongoing debate about the extent to which the country may be losing income through all-inclusive packages, time-share arrangement, vertical integration of firms/companies, mergers and/or acquisitions and unfair competition through loopholes in the institutional and legal framework.

2.6.2 Anti-competitive practices

Another considerable barrier is the market domination by large integrated suppliers. World tourism is characterized by increasing anti-competitive and predatory behaviour from dominant, integrated suppliers in the originating tourist markets.[24] These dominant players, with superior supply capacity, are found in all segments of tourism including transport, CRS/GDS, tours, travel agency and hotels. Thus, more than 60 per cent of tour packages are sold by integrated suppliers in Europe, which are able to bypass local tour operators and to exact enormous discount rates on accommodation and other tourism services. Other ways in which competition is affected include discriminatory use of information networks, predatory pricing, allocation of scarce resources and ancillary services to air transport, exclusivity clauses in favour of the dominant suppliers and refusal to deal, and tied sales, among many others. These anti-competitive practices constitute a considerable obstacle for Kenyan tourism. Big tour operators/travel agents, as in Germany, for example, use their might to squeeze margins from Kenyan hotels. Currently, GATS does not deal with the problem of anti-competitive practices in tourism, yet developing countries such as Kenya require safeguards to protect their domestic industries against these large integrated suppliers.

2.6.3 Distribution systems

Similarly, CRS/GDS pose substantial market barriers for developing countries, including unfair restrictions to access, restrictions on display, high costs due to monopolistic tendencies, neutrality and regulations, technology gap among users, and infrastructure deficiencies and professional constraints. These systems are controlled by the major airlines and most developing country carriers and other service suppliers have no privileged access to them. Fortunately for Kenya, Kenya Airways is a major shareholder in one such system, Galileo Kenya. With Galileo facing competition from Amadeus, moreover, CRS/GDS services have improved considerably.

2.6.4 Travel advisories

One of the main barriers to tourism exports that Kenya has faced is in the form of travel advisories. These led to the world's largest tour operator, the United Kingdom's Touristic Union International (TUI), to cancel its Kenyan bookings for the 2003/04-winter season in mid-October 2003, which sent a negative signal to other travel managers. The advisories almost brought the tourism sector to its knees. The problem with the advisories is that the information on which they are based is not always truthful and no warning or consultation is made to or with the country.

2.6.5 Air accessibility

Despite considerable improvement over time, some barriers over air accessibility remain. First, Kenya does not have Bilateral Air Service Agreements (BASAs) and Communications Management Units (CMUs) with all European Union countries, only the main ones. With respect to the European Union countries with which Kenya does not have or has not reviewed BASAs and CMUs, there are limitations with respect to the number of passengers that can be uplifted per

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[24] The discussion on anti-competitive behaviour borrows heavily from Diaz (2001), where more details can be found.

week. With respect to all European Union countries, moreover, there are restrictions on the "beyond point" of the fifth freedom traffic rights.[25] Being reciprocal, Kenya has been reluctant to agree to such rights due to the fear that European Union carriers can use their might to edge local airlines out of the regional markets. Even if the country had such rights, its airlines lack capacity to utilize them. The country has moreover been reluctant to liberalize "change of gauge"[26] on reciprocal terms for the same reasons. In the spirit of special and differential treatment, the European Union could consider granting such lights to Kenya without seeking reciprocity. The Kenyan carrier has been prevented from flying into the United States market, as the American authorities are not satisfied with the standards of Kenyan international airports.

2.6.6 Other barriers

Besides the barriers briefly discussed above, there are many others. Studying the GATS schedule of commitments for the European Union and some of its new members, Ikiara (2005), borrowing extensively from te Velde et al. (2004), finds the following barriers:

(a) With respect to consumption abroad (Mode 2), which is the main mode through which tourism services are traded, there are no major barriers, with the possible exception of CRS and provisions to safeguard the health and safety of tourists. The coverage of national health insurance for European Union nationals outside the European Union is also a barrier. There are also European Union-wide and State-specific regulations on health tourism.

(b) With respect to commercial presence (Mode 3), services considered as public utilities may be granted monopoly power in the European Union. Individual member States have such limitations as real estate purchase, maximum number of voting rights, or maximum number of shares in a company; and some countries in the European Union have economic needs tests, for example with respect to tour operator services in Italy. This means that if Kenyans apply to set up such services in Italy, they will have to wait for Italy to do an economic needs test first.

(c) Movement of natural persons (Mode 4) is seriously hampered by the current European Union regime in the form of economic needs tests, diploma requirements, nationality requirements, and outright restrictions on movement of less-skilled workers or short-term workers. Movement of natural persons is generally not bound except for intra-corporate transferees (who must have worked for the company for at least a year and must be either a manager or specialist), service supplier representatives visiting for the purpose of negotiating sales, senior person of a service provider visiting to establish commercial presence, and temporary service suppliers who meet certain criteria (when the service contract has been obtained within three months following tendering procedures, where the person has supplied the service for at least a year,[27] for a period of not more than 3 of 12 months[28], and where the person must possess the necessary academic qualifications and professional experience). Other problems include (i) lack of clarity and transparency in the implementation of immigration regulations, policies and procedures; (ii) restrictions on how long these special categories of natural persons can stay, for example a maximum of five years in Estonia and Latvia; (iii) non-recognition of diplomas by the European Union and the right to decide whether to recognize or not individual member

[25] This refers to the situation where, say between United Kingdom and Kenya, Kenya Airways and other designated airlines from the country are allowed to serve other destinations from London or British Airways is allowed to serve, say South Africa, from Nairobi.

[26] This refers to the practice where, say British Airways, would be allowed to use smaller aircraft to distribute passengers to regional destinations upon uplifting them to Nairobi with larger aircraft.

[27] At least two years in the case of Greece.

[28] Not more than 3 of 24 months in case of the Netherlands.

States; (iv) subjection of foreign service suppliers to the European Union and member States' working conditions, minimum wage requirements, and collective wage agreements, which undermines the comparative advantage of Kenyan labour; and (v) restriction of enjoyment of subsidies to citizens or legal persons in some of the new member States. Specifically for tourism, there is a nationality limitation in some of the European Union countries. Thus, only nationals are allowed to offer tour guide services in Greece, Spain, France, Italy and Portugal. In Italy and Sweden, moreover, a professional certificate and three years experience are required. The graduates of Utalii College are getting employment opportunities abroad, especially in the United Kingdom. In spite of their qualifications, however, they are at times underpaid in some countries, which raises the issues of recognition of certificates in the export markets as well as discrimination on the basis of country of origin.

(d) Liberalization of Mode 4 (through binding of intra-corporate transferees) and Mode 1, conditional on commercial presence, (as in Poland, where Mode 1 for tour operators and travel agents is unbound except when there is commercial presence) also constitutes a barrier to a country such as Kenya, which has a comparative disadvantage in capital required to establish a commercial presence. Indeed, the interviews conducted in the last year or so have been unambiguous that capital limitations are among the leading impediments to the establishment of commercial presence overseas by Kenyan tourism enterprises.

(e) Tour guide services are not bound at all in some of the new European Union countries such as Lithuania (except when there are bilateral agreements) and Poland.

2.6.7 Capacity-related barriers

While the market access, national treatment, and other barriers described above are critical, the most significant barriers for the Kenyan tourism industry are capacity-related. Thus, the amount of challenge, competition and capital requirements that characterize operations in overseas markets put them in an entirely different league from the one the Kenyan businesses are currently playing in. The difficulty of penetrating the tight networks[29] that exist in these markets by foreign firms presents a further challenge to Kenyan firms dreaming about playing in that league. Insufficient research in those markets, moreover, worsens capacity problems for Kenyan tourism businesses wishing to do business there.

2.7 Conclusions: opportunities and challenges

Tourism is an important sector of the Kenyan economy, in terms of contribution to GDP, employment and foreign exchange earnings, among others. There are considerable constraints to domestic supply capacity, however, and the country needs to negotiate with development partners for assistance to address these bottlenecks. Further development of the sector should focus more on the micro, small and medium-sized enterprises and creation of strong linkages between the formal activities and the less formal community-based activities. The developed world is a major export market for Kenya's tourism exports. There are significant market access and national treatment barriers in those markets, however, mainly with respect to restrictions on movement of professionals who supply tourism services, and restrictions of some forms of tourism business. The range of restrictions varies widely from one country to the next. Having almost fully opened up its tourism sector, Kenya should negotiate persistently to have its trade partners ease or remove the restrictions they have in their markets.

[29] Whereby firms involved in the networks have complementary needs (such tour operators and airlines), have developed trust and closeness over time, and know the market well.

2.7.1 Main steps to ensure short- and long-term efficiency, viability and sustainability of tourism in Kenya

A sector that is not efficient, viable and sustainable can hardly sell services in the local or overseas markets. The **first step** should be to develop and implement an overall pro-poor tourism development strategy targeted at encouraging and stimulating linkages between the formal tourism sector (hotels, lodges, restaurants, tour operators and transport providers) and the local economy, developing local sources of supply and facilitating local ownership. Various studies have recorded the viability and importance of pro-poor tourism strategies in South Africa, Namibia, Gambia, Kenya and Uganda. Since a draft National Tourism Policy has already been developed, it should be finalized on the basis of recommendations made and then tabled before the Cabinet for approval as soon as possible.

The development strategy should include the following key elements:

- An incentive system that recognizes and rewards outstanding local linkage and outsourcing (both forward and backward linkages), and joint ventures. For example, potential local linkage could be used as a criterion to award planning permissions, leases or concessions.
- Capacity-building for new microenterprises to access affordable credit, acquire marketing skills, improve understanding of tourist expectations, and meet health, safety, licensing and other regulatory requirements through capital, training, information, advisory and mentoring services, and through entrepreneurship development programmes.
- Training to build local and national capacity for sustainable tourism development. The Kenya Utalii College has played an important role in positioning the country relatively well against tourism competitors in the region. The problems facing the college (including inadequate capacity, facilities and lecturers) should be addressed and the college upgraded to a hospitality university.
- Support for the development of new commercially-viable products that benefit the poor, and inclusion of micro, small and medium enterprise tourist products in local and national marketing efforts. In other words, new tourism products should be built on resources that the poor own or have access to.
- Identification and recognition of the community-based tourism subsector and ensuring that the policy framework allows and facilitates involvement of local communities.
- Development of institutions of destination partnerships involving the various government agencies involved in the industry, the tourism industry (in the originating and destination countries), civil society and the local communities. The potential of strong public–private partnership in tourism promotion was demonstrated in November 2000 when KTB coordinated an effective team of public and private sector partners to prepare for the World Tourism Market fair in London. Kenya beat hundreds of competitors to win.
- Institutional reforms to provide more efficient public sector organizations with narrower and more specific mandates, and improved coordination between the Government, donors and NGOs.
- Development of a minimum level of infrastructure to facilitate growth of sustainable tourism. Such development should be linked to the marketing vision developed from current and future market analysis.
- Transfer of modern management techniques and technologies from the European Union, which is the world's leading tourist destination, and other tourism leaders in the world.

- A comprehensive resource, infrastructure and market audit of the tourism industry to aid in proper tourism management and planning.
- Improved resources for marketing and marketing strategy by placing Kenyans who have a special attachment to the country (rather than foreigners) at the center of the efforts.
- Improvement of procedures involved in the issuance of visas and work permits. This could be done a number of ways, including use of Internet for providing information on visa and work permit requirements and for submission of applications, and exemption from economic needs tests (ENTs) skills that are in short supply in the country.

The **second step** should be to review all the laws and regulations touching on tourism, on the basis of the finalized national tourism policy. Specifically, the regulations that hinder trade and investment should be simplified or eliminated.

2.7.2 Role of trade conditions in promoting domestic tourism capacity in Kenya

Trade expansion is crucial for Kenya to promote its domestic supply capacity, considering the huge idle capacity that exists, especially in the accommodation sector. For tourism trade to expand and benefit the country, Kenya should negotiate, under the special and differential treatment provisions of GATS, for the following:

- Credit for the autonomous liberalization of tourism and travel-related services that Kenya has undertaken over the years. In particular, and in the spirit of asymmetric principle, the country should not be pressured to increase the scope and coverage of commitments.
- Further developed country commitments, especially with respect to Mode 4, including those that ease the visa process, and expansion of the list of support staff that could be allowed to accompany executives into developed country markets to supply tourism services to include less-skilled workers.
- Recognition of professional qualifications of tourism service suppliers, for instance through special passes.
- Increased supply of information (by developed countries) on the demand for tourism services and the trade barriers in existence, including travel advisories. This could be perhaps more objectively done by a multilateral agency such as WTO.
- Support for the proposed GATS Annex on Tourism. This is important so that (i) tourism is recognized as a cluster so that the effects of related sectors such as air transport and infrastructure on it are addressed, (b) unfair and anti-competitive practices are submitted to GATS disciplines and mechanisms, and (c) the GATS framework can be used to address the environmental, social and cultural impacts of tourism, and therefore ensure sustainable tourism development.
- Increased technology transfer through home country measures that stimulate the flow of the right kind of foreign direct investment to Kenya.
- Removal of restrictions on commercial presence of foreign tour operators, travel agencies, restaurants and hotels, ENT requirements, and cumbersome and discriminatory licensing requirements, among others.
- Greater liberalization of global air transport services. In the spirit of special and differential treatment, in particular, developed countries could consider granting such rights as “beyond point” of fifth freedom traffic rights and “change of gauge” to Kenya, without seeking reciprocity.

- Emergency safeguard measures in the event of balance of payment problems, which could include the right of Kenya to introduce the requisite regulations.

2.7.3 Other necessary forms of international support or complementary actions

Other forms of support and actions that international agencies could offer or take include:

- Adequate and flexible resources to develop the domestic supply capacity of tourism services in Kenya. The resources should be directed to the projects that meet the objectives of the overall tourism development strategy.
- Support and technical assistance in the development and maintenance of airport and aviation infrastructure in order to meet ICAO standards, provision of concessions, technical know-how and other capacity to help Kenyan airlines to join global code share schemes, and encouragement of international airlines to establish maintenance bases in Kenya with local participation.
- Since many Kenyans hardly even dream about establishing tourism businesses in developed countries, owing to capital limitations, developed countries could offer some of the development assistance in the form of support to such businesses. This would have the effect of helping the relatively small-scale businesses cope with pressure from the large integrated suppliers.

2.7.4 Steps, rules and commitments necessary to ensure gradualism and flexibility of tourism liberalization

Kenya has already made almost full commitments in its tourism services sector, with the exception of some restrictions on movement of natural persons. These commitments were made in 1994, when there was little understanding of possible implications. It would be in the interest of the country, therefore, to renegotiate its commitments in tourism to provide for conditions such as local employment, partnership with locals, preferential treatment of locally-owned tour operators and travel agents, and restrictions on tour guide services. Ways of ensuring gradualism and flexibility of tourism liberalization, therefore, would be:

- To make the process of revising or reducing commitments easier, even only for a fixed period aimed at correcting mistakes.
- To improve and tighten GATS so that issues and positions are clear, leaving no debate to what is acceptable or not, and words such as “objective”, “reasonable”, and “impartial” are clarified.
- For Kenya to formulate and adopt a strategic approach to trade liberalization and foreign participation. Such an approach should include (a) building of national capacity and expertise to conduct comprehensive research on implications before further commitments are made, and to negotiate trade and other agreements; (b) providing affirmative action to small-scale, widely dispersed and locally-owned enterprises, including SMEs; and (c) promoting the use of local airline and tour operators, increase in the proportion of wildlife safari content in the country’s tourist product, and increase in import substitution.
- For Kenya to develop an elaborate process of consultations to ensure that all stakeholder groups, including local Governments that often regulate and deliver tourism services, are effectively consulted before further commitments are made.

Chapter three
Telecommunications

3.0 Introduction

Many studies around the world, notably by ITU and the World Bank, have demonstrated a correlation between ICT development and economic development, with developed countries having the lion's share of telecommunications services. By January 2000, for example, World Bank and ITU studies indicate that the 15 per cent of the world's 6 billion people who lived in high-income countries had 58 per cent of the world's telephone lines and 69 per cent of the mobile telephones, and constituted 82 per cent of the world's Internet users. On the other hand, the 60 per cent of the 6 billion people who lived in low-income countries had only 30 per cent of the world's telephone lines and 20 per cent of the mobiles, and constituted only 10 per cent of the world's Internet users. There is also emerging evidence on the direction of causality. The World Bank (2005), for example, cites the following examples:

- Investments in telecommunications in developed countries over the last 20 years appear to have not only followed growth, but also fuelled it;
- Garment manufacturers in Bangladesh, China, Ethiopia and India are more productive, pay higher wages, and grow faster when telecommunications services are better; and
- A 10 per cent increase in the number of main phone lines per worker in Latin America is estimated to raise output per worker by about 1.5 per cent.

Not surprisingly, therefore, the United Nations not only holds the WSIS, but has also included ICT in the Millennium Development Goals.

In spite of this importance, however, firms in most developing countries, especially in sub-Saharan Africa, have to cope with poor and expensive telecommunications services. According to the World Bank (2005), the problem is not just lack of adequate resources. Rather, like other infrastructure services, the problem of telecommunications provision stems also from market power, irreversible investments and politics. The report elaborates as follows:

- Due to economies of scale, there is a tendency towards concentration of market power in one or a few service providers. Thus, service users fear that the providers will use their market power to overcharge them.
- The telecommunications sector, like other infrastructure services, tends to be characterized by rather immobile and irreversible investments. Thus, investors fear that they may fail to cover their costs if the Government changes regulations by, for example, introducing price limitations.
- Private investment in telecommunications and other infrastructure has been declining in the last few years because of (and fear of) political interference and thus poor returns.

The report notes, however, that technological progress (such as the advent of mobile telephony) and liberalization around the world have transformed telecommunications to the extent that providers and investments need not be monopolies or immobile, respectively, any more.

Kenya's telecommunications sector has undergone important transformation, especially since the 1990s. During pre-independence and the period when the EAC had its first stint (1966–1977), telecommunications services in East Africa (Kenya, Uganda and the United Republic of Tanzania) were delivered jointly. A regional public body, the East Africa Posts and Telecommunications Corporation (EAP&TC), which was established in 1967, played a major role in this service delivery. When the EAC collapsed in 1977, the Kenya Posts and Telecommunications Corporation (KP&TC) was established to continue offering the same services in Kenya. The corporation monopolized the sector and combined both regulatory and operational responsibilities. It continued to deliver services on this basis, with increasing inefficiency and with little trade or value addition, until 1998, when considerable reforms were introduced. Since then, the sector has been gradually liberalized with great impact. Mobile telephony and Internet services, in particular, have achieved high growth in a few years. Nevertheless, the country is still poorly served in fixed access telecommunications services, waiting time for connection is excessive, tele-density is still low, geographical coverage is poor, telephone calls are expensive, and broadband Internet access is limited and expensive. Frequent policy reversals, poor infrastructure and low capacity, high costs and lack of a legal and regulatory framework for execution of e-business are still major constraints on business competitiveness in the country.

Thus, by independence in 1963, the Government of Kenya had recognized the critical role of telecommunications in the improvement of the social, political and economic well-being of Kenyans. This recognition has continued ever since. Thus, for example, the Poverty Reduction Strategy Paper (PRSP) and the Economic Recovery Strategy for Wealth and Employment Creation 2003-2007 (ERS) are committed to attainment of a knowledge-based society status.

This chapter discusses how short- and long-term efficiency, coverage and affordability of telecommunications services could be ensured through (a) e-commerce; (b) trade and trade-related conditions; (c) gradual and flexible liberalization; and (d) through regional, subregional and multilateral rules and commitments. It analyses the main features of the sector, the main players and their characteristics, the legal and policy framework, the regulatory institutions and the main challenges they face, the performance trends over time and in comparison with the other East African countries, and the linkages telecommunications are having with other economic sectors (especially development of computer and related services, off-shoring, ICT-enabled sectors, and SMEs in the use and supply of telecommunications services).

3.1 Policy, legal framework and structure of telecommunications

The policy and legal/regulatory frameworks for telecommunications services in Kenya have undergone important changes in only a decade or so. Within that short time, the sector has moved from being largely monopolistic and inefficient to one of the most vibrant sectors of the Kenyan economy. As the frameworks changed, structure followed and performance improved dramatically. There are now many players in the sector, offering an increasingly varied range of services including value added ones. This section paints the transformation in the policy and regulatory environments, and in the structure of the telecommunications sector in the country. The consequent improvement in performance is discussed in the next section.

To provide a basis upon which the legal/regulatory, policy, and other areas of performance are evaluated, it is important to consider best practices in telecommunications services provision. World Bank (2005) provides such a basis:

- Secure property rights, through development of rules and institutions that constrain market power without compromising on property rights, are important to deal with the problems of market power concentration and irreversible investments. An example of the required rules and institutions is establishment of an independent regulatory agency to jointly secure investor and public protection.
- Competition engenders legitimacy and strengthens investors' property rights. Competition can be increased through privatization, as this enhances genuine competition and results in reduced costs of the service, a shorter waiting time before connection, and faster expansion of services, among others. It can also be increased through credible government commitment against interference with commercial decisions and assurance to consumers about their protection.
- Optimal regulation and taxation, as well as elimination of corruption and access to financing, are also critical elements of an enabling investment climate. Transparent regulations and investor rights that cannot be changed unilaterally and that are perceived as legitimate by consumers, international or domestic arbitration on disputes when investors lack confidence in the local judicial system, and transparent competitive bidding to award tenders are some of the specific policies required to establish the required investment climate.
- Improving public management is also very important. This includes optimal allocation and administration of resources to infrastructure, and adoption of the best form of government organization to optimize service delivery.

3.1.1 Evolution of policy and legal framework

3.1.1.1 Historical overview

The history of the legal framework for the Kenyan telecommunications sector started with the EAP&TC Act of 1967, which mandated a regional public body to deliver postal and telecommunications services in East Africa. There was very limited trade in and value addition of telecommunications then. With the breakup of the East African Community in 1977, the KP&TC Act Cap 411 of 1977 was enacted so that a new corporation could continue offering the same services at the country level. The services were thus delivered within a monopolistic public sector structure, which combined regulatory and operational responsibilities in the same institution.

Reforms in the sector were introduced in a small way in 1990 when the Government relaxed the control of non-strategic functions in the telecommunications sector, in particular the liberalization of vending of customer terminal equipment. In 1991, market access and ownership requirements were relaxed, as was the liberalization of supply, installation and maintenance of internal telephone wiring and customer premises. Then, in 1992, KP&TC introduced cellular services in an experimental way. The following year, an international NGO (African Regional Center for Computing), in partnership with Africa Online, introduced Internet services. The climate, legal and regulatory environment at the time was, however, not conducive to the new services.

Further changes with regard to licensing and registration of vendors and contractors were introduced in 1995, as was further liberalization of supply, installation and maintenance of external wiring in 1996. In 1997, a policy paper introducing broader restructuring of postal and telecommunications services was published. In 1998, the Government enacted the Kenya Communications Act, which repealed the KP&TC Act and ushered in a new legal and regulatory framework. Then, in 1999, Government Telecommunications and Postal Sector Policy Guidelines were issued and revised in November 2001. These regulatory and policy frameworks brought on broad reforms that would eventually end public sector monopoly. In particular, they paved the way for liberalization of Internet and telephony services to allow private sector participation since 1999. The act restructured KP&TC by splitting it into three entities: the Communications Commission of Kenya (CCK) to regulate the sector, Telkom Kenya to deliver telecommunications services and Postal Corporation of Kenya to provide postal services. These bold reforms introduced an environment suitable for private sector participation in service delivery (cellular telephone and Internet), and competition and equity participation from both local and foreign investors.

A new market structure for provision of telecommunications services was approved (table 3.1). Through the dynamism and built-in flexibility of the 1998/99 policy and legislation, Telkom Kenya was granted a monopoly, up to June 2004, on all services, with the exception of customer premises equipment, internal and external wiring, value added services, mobile cellular services and local telephone access services. In the case of local telephone access services, Telkom was granted monopoly, but for Nairobi only.

Table 3.1. Approved telecommunications services structure, 1999

Customer premises equipment	Mobile cellular services
Internal and external wiring	Mobile satellite services
Resale services (value added services)	Local telephone access services
Internet backbone	National long distance telephone services
Very Small Aperture Terminal (VSAT) services	International long distance telephone services

The participation of SMEs in the non-Telkom exclusive services increased substantially thereafter. By 2001, for instance, CCK and Telkom Kenya records show that there were 235 registered equipment companies, 72 ISPs, 100 cybercafes, and a sizeable number of professionals providing consultancy and support services. By 2004, moreover, many more operators had been licensed in different market segments (table 3.2). For instance, there were 888 contractors and vendors, 78 ISP providers, and 78 VAS providers (table 3.3). Annex 2 provides a more detailed schedule of the players in the communication sector.[30]

Table 3.2. Licensed telecommunications operators, Kenya

Type of operator/service	Licensed operators
Fixed-line operators	• Telkom Kenya Limited, a national operator • Bell Western Limited, a regional operator
Mobile operators	• Safaricom Limited • Kencell Communications Limited • Licensing of third mobile operator not yet completed
Internet backbone operators	• Telkom Kenya Limited • 10 were gazetted for licensing on 3 September 2004
Public data network operators	• 6 operators, including Telkom Kenya Limited
Internet service providers (ISPs)	• 78 licensed, but less than half are operational
Internet exchange point providers	• 2
Local loop operators	• 4 licensed • 2 were gazetted for licensing on 3 September 2004
GMPCS service providers	• 1 was gazetted for licensing on 3 September 2004

[30] The particulars of the players can be found on the CCK website: www.cck.go.ke: Telecommunications – licensed operators and service providers.

VAS-premium service providers	• 17 • 1 were gazetted for licensing on 3 September 2004
National commercial VSAT operators	• Telkom Kenya Limited • Alidean Satellite Network (Kenya) Limited • 2 were gazetted for licensing on 3 September 2004
Postal operators	• Postal Corporation of Kenya (PCK)
Private courier operators	• 74
Broadcasting	• 12 television broadcasters

Source: CCK.

The country's telecommunications sector was further restructured through the post-exclusivity policy and regulatory framework. Following the expiry of the exclusivity (monopoly) period for Telkom Kenya on 30 June 2004, CCK formally announced the full liberalization of telecommunications sector on 8 September 2004 with the coming into force of a new regulatory framework. The new framework provides that:

- Cellular mobile operators can opt to operate their own international gateways, and provide for diversity in international links and roaming facilities.
- Public data network operators are free to establish international gateways for data communication services.
- Internet backbone and gateway operators, broadcast signal distributors, commercial VSAT operators and public data network operators have freedom to carry any form of multi-media traffic, thereby allowing for IP (Internet protocol) telephony services.
- Licensing is on a first-come-first-served basis subject to demonstration of capacity to deliver services. There is possibility of unified licensing.

Table 3.3. Number of players by market segment, 1999/2000–2003/04

Market segment or licence category	Number of licensees (cumulative)				
	1999/2000	2000/01	2001/02	2002/03	2003/04
Vendors and contractors	184	740	783	813	888
Technical personnel	30	71	108	139	182
Cybercafes/telephone bureau	-	-	-	51	70
Internet service providers	43	66	72	76	78
Internet exchange point providers	-	-	1	2	2
Paging service providers	14	16	12	12	2
Value added service providers	-	1	1	3	17
Public data network operators	1	1	1	4	6
Public switched network operators	1	1	1	2	2
VSAT hub operators	1	1	1	2	2
Local loop operators	-	-	-	2	4
VSAT terminal licenses	36	56	75	130	336

Source: CCK.

The sector was restructured into:[31]

- Network facility providers to operate all communication infrastructure, satellites, terrestrial, mobile, and fixed lines;
- Applications service providers; and
- Content service providers.

[31] More details of the new structure are presented in annex 2.

3.1.1.2 Privatization of Telkom Kenya

Another major policy reform was the decision to privatize Telkom Kenya. Privatization through sale of 49 per cent of its equity to a strategic investor, who was expected to invest in the modernization of the network, had been set for 2003. However, the price offered by the highest bidder was so low that the Government held back. To date, the Government has not given clear policy guidelines on the privatization of the company. The latest thinking, however, is that of taking a conclusive privatization option based on a consultancy report submitted to the Government recently. Even after receiving the consultancy report, however, the Government is of the view that privatization of Telkom in its current state will not be feasible. Deeper reforms have to be undertaken to (a) rationalize the workforce; (b) restructure the company's balance sheet to make it a profitable going concern; (c) form a subsidiary to run the Internet business and avoid court disputes with ISP players in the industry; and (d) roll out a fixed wireless service due to vandalism of cables. The privatization of Telkom Kenya will be guided by the Privatization Bill of 2003, which has adequate safeguard provisions to ensure orderly privatization of strategic parastatals. As indicated earlier, privatization is among the best practices in the provision of telecommunications services, and it should be addressed expeditiously.

3.1.1.3 Competition

The Government has fallen behind schedule on a number of commitments intended to further liberalize the telecommunications sector, yet competition is another best practice in service provision. These include licensing of a second national fixed telephony operator by the end of fiscal year 2004/05 and a third mobile operator by December 2003. In addition, the four Internet gateway service providers that were to be licensed during the same period and the VSAT services that were to be completely liberalized were not. CCK has, however, tendered a second national operator and retains the right to issue more licenses and/or regulate price, and other conditions for fixed telephony services until competition in the subsector is adequate.

Liberalization of the international Internet highway has already facilitated licensing of additional service providers. By February 2005, four more companies (Kenya Data Network, Jamii Telcoms, Harum International and Alldean Satellite Networks) had been licensed for provision of Internet backbone and VSAT services. Further, as reported in Business Week magazine of Daily Nation of 1 February 2005, there is a concerted effort in "…Making Universal Telecommunications Access a reality" with regard to availability and accessibility either through multinational telecommunications corporations, SMEs and Government in under-serviced areas. Operator contribution to the Universal Service Fund is expected to spur this effort. These developments are expected to introduce competition in the local bandwidth market and create opportunities for cheaper connectivity, which is essential for rapid development of electronic commerce and other data communications. Additional competition in the telecommunications sector will be created through further commitments within the GATS multilateral trade framework, as will be discussed in a later section of this chapter.

3.1.1.4 Equity participation

In order to encourage Kenyans to actively participate in the sector through equity ownership, the guidelines of 1999/2001 required any firm licensed to provide telecommunications services to have at least 60 per cent of its equity in local hands. However, because of the heavy initial investments required in the sector, coupled with the inability of Kenyans to raise such resources, the minimum local equity participation was reduced to 30 per cent. In addition, a number of market segments requiring minimal investment were preserved for local SME investors. This was done in order for them to build the requisite local entrepreneurial capacity for expansion into the higher ICT technology enterprises. With realistic levels, minimum local equity participation requirements can contribute to an enabling investment climate by establishing legitimacy among stakeholders.

3.1.1.5 Draft ICT policy

Further reforms in the Kenyan telecommunications sector have led to the development of a draft ICT policy through unprecedented stakeholder participation and input. The draft is receiving further stakeholder input before it undergoes Cabinet and Parliamentary approval processes. The draft policy has four main planks:

- Infrastructure development;
- Human resources development;
- Cooperation among stakeholders; and
- Appropriate policy and regulation framework.

The Government undertakes to continue reviewing the policy framework for investment, competition and growth of the industry in order to facilitate commercial decision-making. In addition, the Government undertakes to encourage all investors and operators to:

(a) Participate in the provision of universal service/access;
(b) Attract more private sector resources and develop public/private sector partnerships;
(c) Develop a sector with efficiency, credibility, commercial integrity and good corporate governance;
(d) Provide quality and sustainable service with pluralism of choice to consumers; and
(e) Keep abreast with and participate in ICTs both regionally and internationally.

Aware that there are no active communication consumer lobby groups in the country, the Government undertakes to encourage the formation of consumer and user groups as a way of according them a chance to participate in development of ICTs.

Besides the draft ICT policy, other policies and legislation in place include E-Government Strategy 2004, E-Commerce Strategy 2004, Universal Access to Communication Services 2004 and Information Technology Act 2004.

3.1.1.6 Other recent and ongoing reforms

The Investment Bill of 2004 simplified the procedures of companies setting up business in Kenya, as have the local authorities' single business permit. In addition, improvement in governance expected from the code of ethics and anti-corruption bills of 2004 are steps in the right direction for modernizing service delivery and benchmarking with international standards and markets.

3.1.2 Main players and their characteristics

The main players in Kenya's telecommunications include primary and secondary public sector actors and actors in the private sector.

3.1.2.1 Public sector

The main public sector players in the Kenyan telecommunications sector include the Ministry of Information and Communications, Telkom Kenya, the National Communication Secretariat, CCK, and the Communications Appeals Tribunal (table 3.4).

Ministry of Information and Communications

This ministry was established in June 2004 to be in charge of policy formulation and coordination. Previously, telecommunications functions had been performed through the Ministry of Transport and Information, Ministry of Finance and Office of the President. Since the ministry is relatively new, it has to develop all systems and put in place institutional arrangements to facilitate effective stakeholder participation.

Communication Commission of Kenya

CCK was established following the 1998 restructuring to oversee the operations of the varied players, both public and private, in the industry. The commission in effect separated operational and regulatory roles, which had hitherto been performed by KP&TC. It is an independent regulator. It is charged with the responsibility of regulating info-communications sector and discharging such other functions as (a) licensing; (b) price regulation; (c) approval of equipment type; and (d) management of radio frequencies, interconnection and universal service obligation, among others.

CCK management is vested in a Board of Directors composed of (a) a chair, appointed by the President; (b) the Director General, appointed by the Minister in charge of communications; (c) the Permanent Secretary responsible for Finance; (d) the Permanent Secretary responsible for Internal Security; (e) the Permanent Secretary responsible for Information; and (f) at least five people who are not public servants, appointed by the Minister by virtue of their knowledge or experience in matters relating to postal services, telecommunications, radio communications, commerce or related consumer interests.

Table 3.4. Public organizations with primary responsibility for ICTs in Kenya

Organization	Date founded	Affiliated ministry	Empowering legislation or authority	Mandate	Policy role?	Implementation role?
Communications Commission of Kenya	1998	Ministry of Information and Communications	Kenya Communications Act	Licenses and regulates telecommunications, radio communications and postal services in Kenya. Allocates frequencies for communications and broadcasting.	Yes[32]	Yes
National Communications Secretariat (NCS)	1998	Ministry of Information and Communications	Kenya Communications Act	Advises the government on communications policy	Yes	No
Government Information Technology Services (GITS)	2000	Ministry of Finance	Government reorganization of Micro Information Systems Department	Provides computer services to government ministries, departments and selected parastatals	No	Yes
Directorate of E-Government Office of the President	2004	Cabinet Office, Office of the President	Cabinet Approval of E-Government Strategy	Oversee implementation of e-government strategy	Yes	Yes
Appeals Tribunal	1998		Kenya Communications Act	Arbitrate disputes under Kenya Communications Act	No	Yes
Telkom Kenya	1998	Ministry of	Kenya	National	No	Yes

[32] The Kenya Communications Act 1998 does not specify a policy role for CCK. However, in practice, CCK does carry out several policy functions.

Organization	Date founded	Affiliated ministry	Empowering legislation or authority	Mandate	Policy role?	Implementation role?
Ltd.		Information and Communications	Communications Act	telecommunications operator		

Source: Ministry of Planning and National Development (2004).

In CCK's day-to-day management, three Directors assist the Director General. These are in charge of regulatory issues, postal services, and communications services. The commission has about 100 members on staff, which is adequate given its mandate and the size of the communications market in the country. CCK's service delivery has sometimes been handicapped by Telkom Kenya as an incumbent monopolist and lack of qualified personnel to cope with the ever-changing technologies. Nevertheless, in spite of the political and social sensitivity of the issues it handles, CCK seems to be managing in a somewhat efficient manner

Telkom Kenya Limited

Telkom Kenya Limited (TKL) is the main public sector player in the provision of telecommunications services in the country. It was established in 1999 to take over the telecommunications functions of KP&TC following restructuring of the sector. The functions included local telephone services, national long distance telephone services, international gateway services, Global Mobile Personal Communication by Satellite (GMPCS), mobile radio services, VSAT services, Internet node and backbone services, value added services, customer premises equipment vending, and internal and external wiring services.

Lack of resources for investment curtailed telecommunications infrastructure expansion leading to poor services, frequent down time and consumer outcry. According to the National Communication Secretariat (NCS), TKL is operating an out-dated infrastructure, with only 66 per cent of the connections digital by 2001. Furthermore, the company is overstaffed, with a workforce of 18,000 against a capacity of only 321,482 connections in 2001. Companies with similar capacity in the country had only 2,000 employees that year. Thus, TKL has failed to attain the performance targets set by the sector regulator and has been fined. It has been unable to pay the fines.

Reforms targeted for the company include privatization, through invitation of a strategic private partner, and staff rightsizing, both of which have proved very challenging.

TKL is still the sole provider of fixed telephony services and is yet to get effective competition in the provision of backbone Internet services, in spite of the five-year exclusivity period granted to it having expired in September 2004.

National Communication Secretariat (NCS)

NCS was established to provide policy advisory services to Government, among other key functions. The functions of NCS as currently constituted are:

- Formulate info-communication policies and recommendations that aim to advance strategic interests;
- Carry out telecommunications and postal policy, research and analysis;
- Advise Government on the most efficient and effective way of managing the radio frequency spectrum;
- Conduct continuous review of all phases of development in info-communications;

- Assist in the preparation of country position papers for all international meetings and conferences relating to info-communications; and
- Update sector policy statements, sessional papers and legislations pertaining to info-communications.

The secretariat is headed by a communications secretary, who is appointed by the minister in charge of communications on a renewable three-year contract. Four key experts in the areas of communications, radio technology, law, and economics assist the secretary.

The secretariat is constrained by lack of adequate resources, and thus of professional staff, and occasional conflict of roles with CCK with respect to policy advisory matters.

Appeals Tribunal

The Appeals Tribunal was established to arbitrate in disputes arising from the implementation of the Communications Act. A retired Court of Appeals judge leads the tribunal, whose main challenge is the competency to deal with rapid advances in technology. So far, the tribunal has arbitrated on six cases whose outcome has been acceptable to the concerned parties in industry.

Government Information Technology Service

In March 2002, GITS took over the functions of the government Micro Information Systems Department, which provides computer and technology support for ministries and some parastatal organizations. This support includes writing computer applications, updating of existing systems, evaluating system design, conducting feasibility studies, and ensuring that ICT standards within government organizations are harmonized and standardized.

E-Government Directorate

The E-Government Directorate was founded in March of 2004 to oversee the implementation of E-Government Strategy and assist the Kenyan Government to more effectively deliver services to citizens. The E-Government Strategy proposes that each ministry gets its own ICT department. The directorate focuses on three main areas: Government to Government services (G2G); Government to Citizen Services (G2C); and Government to Business Services (G2B). Among other tasks, the E-Government Directorate (a) evaluates government websites for content, usefulness, and relevance; (b) holds breakfast meetings with information and communication offices; (c) tries to stimulate the interest of civil servants in e-government; (d) highlights the ways that offices can use ICT to cut down on costs; and (e) organizes training for staff within ministries. One of the initial activities is the implementation of e-mail for all civil servants.

Secondary public sector players

The secondary ICT players in the public sector include (a) the Ministry of Education, Science and Technology, whose mandate over the National Council of Science and Technology enables it to handle training; (b) the Kenya Bureau of Standards, which supervises and develops standards on many telecommunications-related projects such as transmitters, masts and towers; and (c) the National Environmental Management Authority, which approves installations of large equipment, such as masts and towers and demands environment impact assessments before implementation of projects.

3.1.2.2 Private sector

As is evident from tables 3.2 and 3.3, the number of private sector players in the country's telecommunications sector increased as reforms deepened in the 1990s and 2000s.

Customer premises equipment vendors

There are over 235 registered companies in the customer premises equipment vending market segment, about half of which are active. The bulk of the foreign investment comes in the form of multinationals with branches or representatives in Kenya. The local business entities have concentrated in the segments that do not require heavy investment or technology uptake. These segments include equipment vending, sale/distribution of mobile phones and repairs.

Computing and Internet Service Providers

The first ISPs in Kenya came into operation in 1999, while the largest ones entered the subsector in 2000. Between that time and 2003/04, the number of licensed ISPs had almost doubled (table 3.3). Some of the major ISPs that set up shop immediately after the telecommunications services were liberalized and currently command a sizeable market share include Swift Global, Africa Online, Wananchi Online, UUNET, NairobiNet, and Mitsuminet. Other newcomers with sizeable presence include Postal Corporation of Kenya, SahanNet, and JamboNet. The capacities of the ISPs are, however, constrained by the quality of service from the backbone service provider.

Cellular telephone companies

There are two cellular companies (Safaricom and Celtel) in operation, while the third (EcoNet Wireless) is expected to roll out its network any time. With enormous capital injection by the private sector (both local and foreign), these two companies have exceeded the performance targets set for them by the industry regulator, CCK.

Safaricom Kenya Limited

Safaricom Kenya Limited is Kenya's leading mobile telephone operator. It was formed in 1997 as a fully owned subsidiary of Telkom Kenya to take over the mobile services started under KP&TC in 1992. In May 2000, Vodafone Group Plc (United Kingdom), the world's largest telecommunications company, acquired a 40 per cent stake and management responsibility for Safaricom. Safaricom's strategic association with world leaders such as Linksoft in mobile telephony has enabled the company to gain access to cutting-edge technology, which has in turn facilitated diversification of services and product range at minimal cost to the company and therefore competitive pricing.

Currently, Safaricom provides both prepaid and postpaid services and roaming services in partnership with the South African company Vodacom. Combining this with a network management system ensures that Safaricom can deliver a quality service to its growing subscriber base. Safaricom has also combined social corporate responsibility with profitability and delivery of quality services. In addition to providing social services to its employees, Safaricom has sponsored a number of projects for the common good. These include the fencing of Mount Kenya forest to secure the security of the elephants and sponsorship of Kenyan athletes to international functions.

Celtel

Celtel started as Kencell Communications Ltd., a fully private GSM operator, founded following the liberalization of the telecommunications industry in 1999. The company's shareholding at inception was 40 per cent by Vodafone of the United Kingdom and 60 per cent by a local family company, Sameer. In 2004, Celtel of the Netherlands acquired 60 per cent of the interest and consequently changed the name of the company from Kencell to Celtel, and assumed management of the company.

Kencell
Kencell selected the appropriate Free Space Optics technology to further expand the network infrastructure and provide bandwidth where it was needed quickly and cost-effectively. This innovative technology guaranteed quality connection to one of the country's most reliable and fastest growing GSM networks.

EcoNet Wireless
EcoNet Wireless of South Africa was licensed in 2003 but has not started operations because of prolonged litigation problems. The company is, however, expected to roll out its network any time now following a favourable court ruling on 1 March 2005.

3.1.2.3 Private sector associations and the civil society

In the recent past, a number of trade associations and civil society groups have emerged which have had an impact on Kenya's ICT policy process. The most notable among these are Tespok, KIF and Kictanet. Tespok represents the ISPs in Kenya and has successfully lobbied Government regarding IXPs and VSATs, encouraged the Government to establish the Ministry of Information and Communications, and has set up exchange points with other countries. Tespok started operations in 2002 and established the Kenya Internet Exchange Point, a facility through which the country's ISPs exchange local Internet traffic locally, thereby improving the quality of service.

KIF is an umbrella body that brings together all private sector organizations with an interest in ICT. Tespok and the Computer Society of Kenya are members of KIF. KIF has lobbied vigorously for the finalization of Kenya's ICT policy.

Kictanet is a recently formed civil society organization. It is a loose network of donors and NGOs. Kictanet has collected comments from various parts of Kenyan civil society regarding the ICT policy and forwarded them to the ministry. Overall, the relationship between civil society, the private sector and Government with regard to ICT has improved since the current Government took power in December 2002. The entities are working more closely, and civil society and the private sector are taking an interest in building government capacity in this sector.

3.2 Effects of policy and regulatory changes on performance

Due to a policy and regulatory framework that favoured a public monopolistic structure between independence and the early 1990s, there was considerable delay in bringing on board the private sector and civil society in matters of ICT policy formulation, implementation and technology uptake. This led to loss of opportunity for synergy and therefore faster growth. In almost eight years when the public monopoly KP&TC had introduced mobile telephony and Internet services, for example, only 20,000 mobile users were connected and the Internet services did no better.

Several studies have demonstrated the benefits of privatization and competition in telecommunications. Rossi (1999), Fink et al. (2002), Li and Xu (2001), Wallsten (2001), and Ros (1999), show that countries achieved significantly higher tele-density (mainline penetration), a higher tele-density growth rate, and improved efficiency (in terms of the number of telephone mainlines per employee) after allowing majority private ownership in their incumbent telecom operator. Fink et al. (2002) find that countries with a comprehensive telecommunications reform programme (consisting of privatization, competition and an independent regulator) achieved a higher level of main lines and productivity relative to countries with partial or no reforms.[33]

This section shows how the performance of Kenya's telecommunications sector changed as policy and regulatory reforms were deepened since 1992. In general, the policy framework has created a fairly competitive sector, although effective competitors for Telkom Kenya, especially with respect to fixed telephony and Internet backbone services, are yet to emerge.[34]

3.2.1 E-readiness

As will become evident in subsequent subsections, Kenya has made dramatic strides in telecommunications services since reforms in the sector were started in the early 1990s. However, in general terms, much more needs to be done. In 2002, for instance, the country's ICT infrastructure and e-readiness were only modest (table 3.5 and figure 3.1). The country had done fairly well with respect to hardware and software, and development of ICT workforce, was in the third stage (table 3.5 and figure 3.1).

Table 3.5. E-readiness in Kenya, 2002.

Indicator	Stage	Indicator	Stage
Network access		Locally relevant content	2.5
Information infrastructure	2.0	ICTs in everyday life	2.0
Internet availability	2.0	ICTs in the workplace	2.5
Internet affordability	2.0	Networked economy	
Network speed and quality	2.0	ICT Employment opportunities	2.5
Hardware and software	3.0	B2C Electronic commerce	2.0
Service and support	2.5	B2B Electronic commerce	2.0
Networked learning		E-Government	1.5
Schools' access to ICTs	2.0	Network policy	
Enhancing Education with ICTs	2.0	Telecommunications Regulation	2.5
Developing ICT workforce	3.0	ICT trade policy	2.0
Networked society		Locally relevant content	2.5
People and organizations online	2.5		

Key: Stage 1= Lowest Advancement; Stage 2 = Minimum e-exposure and substandard infrastructure; Stage 3 = Relative adequate hardware and software services, with domestic sector supply picking up; Stage 4= Fully prepared for digital global economy (liberalized, fully liberalized networks, full use of e-enabled services).

Source: Ministry of Finance and Planning (2002).

The country's overall staging or state of E-preparedness in 2002 was below 30 per cent of full preparedness, which is between stages 2 and 3 (figure 3.1). To improve Kenya's e-preparedness, therefore, the following critical issues have to be addressed:

- Very low fixed Internet network penetration, especially outside Nairobi. In 2002, the coverage area of the digital leased line network (Kenstream) ranged from only 1.5 per cent in western and north-eastern provinces to 57 per cent in Nairobi (Ministry of Finance and Planning, 2002). Only two of the country's eight provinces had coverage of more than 10

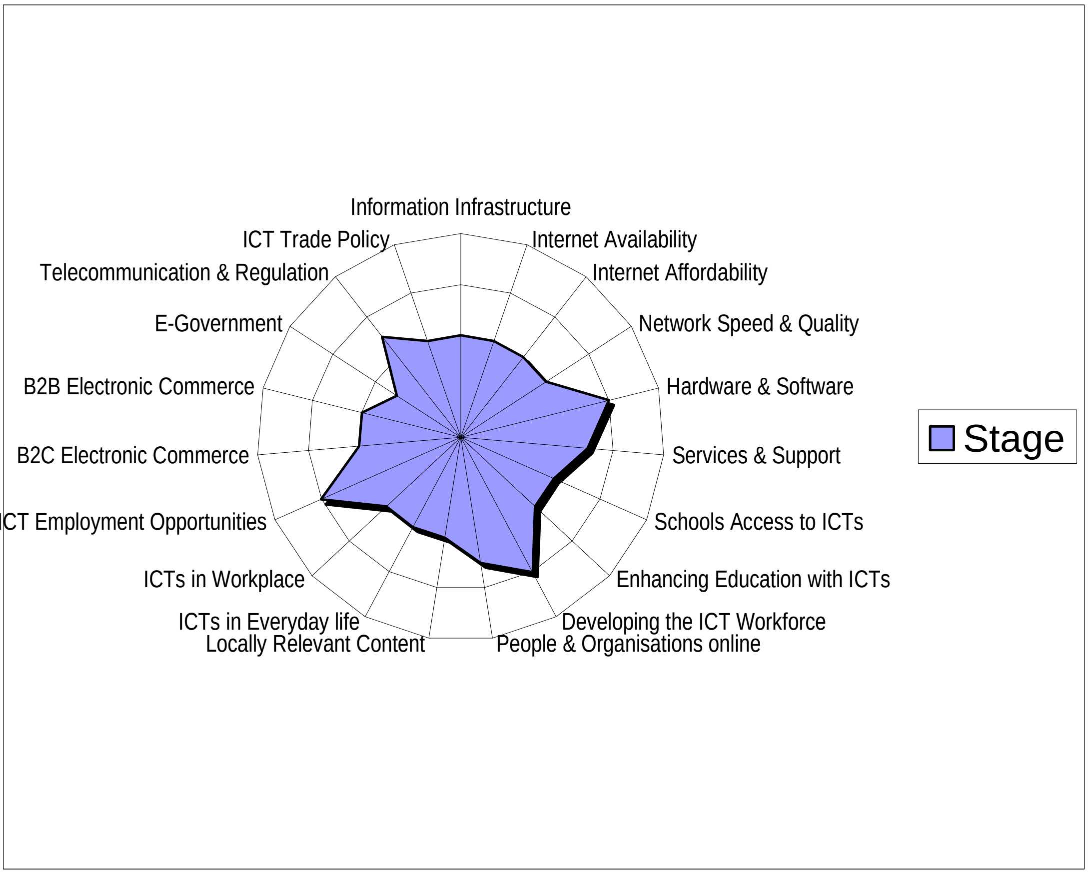
[33] Mainline penetration or tele-density refers to the number of telephone mainlines per 100 people, while productivity refers to the number of mainlines per worker.
[34] A more detailed account of the policy environment status of Kenya relative to its region is presented in table 3.15.

per cent. In addition, there was a very small number of Internet points of presence (POPs) and limited capacity of Internet backbone. Out of the 50 POPs already installed by JamboNet,[35] only 24 were active in 2002 (Ministry of Finance and Planning, 2002). Telkom Kenya remains the only player in the fixed-line telephony and as such has monopoly over critical services, including fixed-line services within the capital city and trunk lines.

- Non-availability of ICT facilities in educational institutions.
- Low level of awareness of the usefulness of ICT in business and everyday life.
- Limited availability of commercial information such as catalogues, price lists and industry-based price and quality comparisons.
- Absence of legislation relating to e-commerce and e-government efforts.

It is evident that the most critical issues are linked to network access, whose resolution would simultaneously remove all the other handicaps.

Figure 3.1. E-readiness map for Kenya, 2002



Source: Ministry of Finance and Planning (2002).

3.2.2 Info-communications infrastructure, connectivity and access

Without an efficient information and communication technology infrastructure, the info-communications sector cannot grow satisfactorily. In spite of the extensive reforms taken in the last decade or so and ongoing policy initiatives (including provision of an environment that is conducive for private sector participation) and programmes to facilitate development of the required

[35] The only Internet backbone operation in the country until recently.

infrastructure, the present state of info-communications infrastructure is still a major hindrance to Kenya's full exploitation of the sector's potential.

Infrastructure, connectivity and access in Kenya – as measured by the fixed telephone exchange capacity and the number of connections, tele-density, the numbers of Internet hosts and users and personal computers (PCs), and the number of cellular telephony providers – have improved significantly over the years in response to the changing policy and regulatory environment (tables 3.6 a and b).

Table 3.6a. Telephone exchange capacity in Kenya, 1990–2004

	1990	1992	1994	1996	1998	2000	2002	2004
Exchange capacity, thousands	228	324	346	380	390	405	466	627
Exchange connections, thousands	175	205	222	256	272	301	373	502
Tele-density (Fixed telephone lines per 100 people)	0.738	0.813	0.828	0.905	0.912	0.997	1.17	1.49

Source: Various government documents.

Table 3.6b. Trend of connectivity and access in Kenya, 1995–2004

Connectivity measure	1995	1998	1999	2000	2001	2002	2003	2004
Internet hosts per 10,000 people	0.0	0.2	0.2	0.3	0.93		0.83	
Internet users per 1,000 people	…	…	….	**19.87**	**16.83**	**22.96**	**32.60**	**46.61**
PCs per 1,000 people	0.6	3.4	4.2	1.71	2.55	6.95	7.95	9.84
Telephone main lines per 1,000 people	8.4	9.9	9.9	10.24	10.4	10.32	10.04	8.63
Cellular service providers	0	0	1	2	2	2	2	2

Source: Various government documents.

In the case of the PCs, it appears the Y2K millennium bug scare of 2000 had an adverse impact on purchase of computers. It is only in 2002 that the trend in computer purchase was restored.

Relative to its neighbours, Kenya has done slightly better in connectivity and access, but much poorer than South Africa (table 3.7).

Table 3.7. Relative performance of Kenya in telecommunications connectivity and access

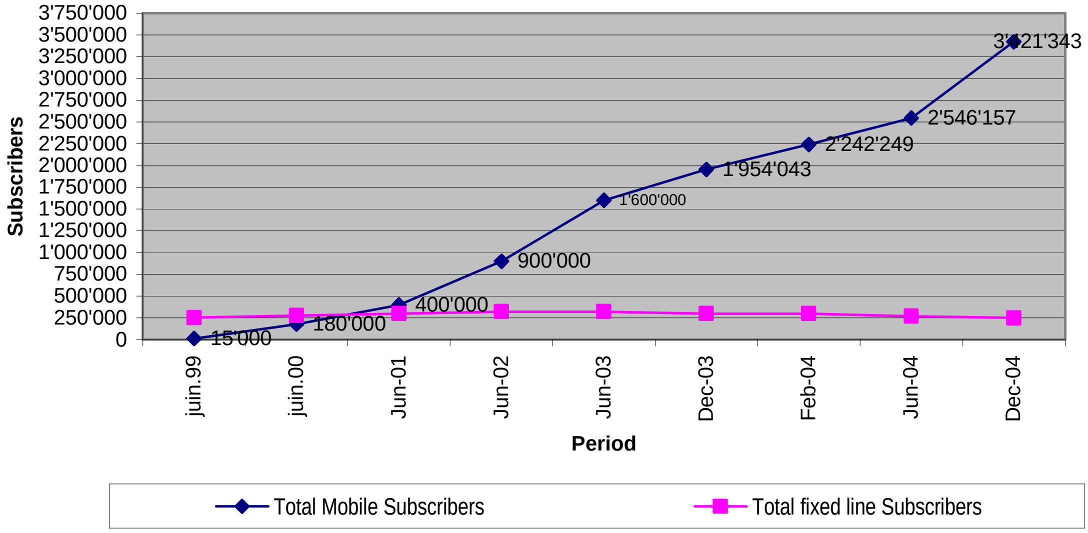
	Kenya	United Rep. of Tanzania	Uganda	South Africa
Fixed telephones per 100 people	1.0	0.4	0.2	-
Faults per 100 lines	220.9	24.0	-	48.2
Days required to obtain telephone connection	124	23	38	-
Cellular telephones per 100 people	4.15	1.27	1.59	-
Internet users per 10,000 people	159.8	29.8	25.2	
PCs per 100 people	0.6	0.4	0.3	

Source: UNCTAD (2005b).

3.2.2.1 Telephony

The development of the telecommunications sector since around 2000 has been marked by a dramatic increase in the subscriber base of the mobile services and a stagnation of the subscriber base of fixed-line services (figure 3.2).

Figure 3.2. Comparative growth of fixed and mobile telephony networks in Kenya, 1999–2004



Source: CCK/IDRC (2004).

The mobile network is now over 10 times that of the fixed network. This can be explained by the large capital investment, estimated at $500 million, undertaken by the two mobile services providers in the country.

Tele-density stands at about 0.16 fixed lines per 100 people in the rural areas and about 4 lines per 100 people in the urban areas. The Government's objective is to improve this to 1 fixed line for every 100 people in the rural areas and to 20 lines in the urban areas by the year 2015, which will require an enormous amount of investment. The national telephone penetration factor (the percentage of households/offices with a telephone) stands at about 4.2 per cent[36] but varies widely, from 0.1 per cent in the very remote districts to 27.7 per cent in Nairobi. However, most of the telephones in the urban areas are located in offices rather than in households. Thus, in spite of the adoption of universal access/service policies and explosion of telephony services occasioned by the advent of liberalization, privatization and introduction of the mobile/cellular services, rural coverage still remains deficient. In East Africa, it is only Uganda where a universal service fund has not been set up to subsidize rural telecommunications infrastructure and service delivery.

Fixed telephony services

Telkom Kenya is still the only provider of fixed telephony services in the country, although the five-year exclusivity period granted to the company ended in June 2004 and a second national operator has been tendered. Not surprisingly, therefore, there has been very poor growth in fixed-line connectivity and access, despite liberalization. Thus, the number of subscribers to the fixed telephony network grew from 291,706 in June 1999 to 328,356 in June 2003, but this had dropped to 290,000 by June 2004 (table 3.8). By June 2004, the number of fixed telephony subscribers amounted to only about 48 per cent of the target set by CCK. The demand for fixed telephone lines remains high, however, with the number of people on the waiting list at 116,544 in 1999 and 107,266 in June 2004. The most outstanding achievement in the area of fixed telephony since the early 1980s has been the expansion of public telephone service, with the number of public telephone booths increasing from 588 in 1981 to about 10,000 at present.

[36] Mobile telephone density accounts for most of this, 3.01 per cent.

Table 3.8. Telkom Kenya subscriber targets/performance, 1999–2004

Year	June 1999	June 2000	June 2001	June 2002	June 2003	June 2004
License target	291,706	316,706	376,706	451,706	526,706	601,706
Total subscribers	291,706	309,379	321,482	328,104	328,356	290,000

Source: Telkom Kenya.

International services are offered through the two Earth stations, with switches at Nairobi and Kericho, whose combined capacities are 14,000 trunks. However, infrastructure for regional connectivity remains deficient and is characterized by frequent outages. Sometimes, regional traffic is rerouted via external international gateways, leading to higher cost and limited use.

The country has made encouraging progress in its efforts to modernize the network. Thus, for example, the national level of automation increased from 84.3 per cent in 1981 to about 98 per cent at present. The greatest impact of the automation programme has been felt in the rural areas, where the level of automation improved from 15.3 per cent to about 40 per cent during the period under review. Following the introduction and liberalization of mobile telephony and Internet services at the end of the 1990s, there was a drastic decline in fixed-line international traffic (both incoming and outgoing) for Telkom Kenya. This trend is expected to continue, as Voice over Internet Protocol (VOIP) services, which cost only a fraction of other traditional services, take root.

Fixed telephone line connectivity has stagnated due to capital constraints associated with an unsustainable wage bill and governance problems at TKL, implying that Internet connectivity and e-services dependent on it may suffer.

With full liberalization, there are prospects for additional public–private sector participation in the fixed-line telephone services and resuscitation of the dormant but licensed regional private operators. In addition, the dominance of the public sector in the provision of international connectivity may decline as Internet connectivity improves. Internet telephony services (VoIP) are likely to pick up and may overtake the fixed-line services on account of lower costs.

Cellular telephony services

KP&TC introduced cellular telephone services to the country in 1992, through the analogue system known as the Extended Total Access Communication System, which was commercially launched in 1993. At this time, the services were so expensive that only a few rich people could afford them. The cost of owning a mobile handset was as high as Kshs 250,000. Not surprisingly, therefore, only 20,000 lines were developed over the 1993–1999 period. With the restructuring of the sector in 1998/99 that allowed competition and private sector participation in the subsector, however, there was dramatic improvement in performance. Safaricom and Kencel (now Celtel), the only two companies still offering cellular telephony services in the country, were licensed in 1999 with network licenses obligating them to universal service.

Both Safaricom and Celtel have realized tremendous growth in subscriber rollout from 1999 to 2004, which saw their combined subscriber base reach about 3.4 million by December 2004 (table 3.9) and was expected to reach the 4 million mark by the end of June 2005. The two operators not only covered the areas required by their respective licenses but new areas as well.

Table 3.9. Mobile telephony performance against license targets, 1999–2004

Year	June 1999	June 2000	June 2001	June 2002	June 2003	June 2004
Kencell (Celtel)						
License target	-	0	49,323	162,527	345,354	582,719
Connected subscribers	-	60,000	259,896	458,959	590,785	918,779
Safaricom						
License target	0	0	0	0	0	0
Connected subscribers	15,000	54,000	325,235	728,163	1,000,000	1,627,378

Source: CCK

The enormous growth in the mobile subscriber base notwithstanding, there is still considerable unmet demand for mobile telephony. While there were about 1.6 million subscribers by June 2003, for example, CCK had forecast demand for that year to have had reached 4.7–9.4 million.

3.2.2.2 Internet services

An NGO (the African Regional Center for Computing) and a small private company (Africa Online) introduced Internet services in Kenya in 1993. Africa Online has since grown into one of the largest corporate entities in sub-Saharan Africa. The business environment for non-public sector providers was very hostile then. The size of the Internet services market in the country, which amounted to only 250,000 users a few years ago, had grown to 500,000 by 2001 and 1.3 million by December 2003. Despite increasing liberalization, ISPs still face considerable problems, including high tariffs and poor service reliability, as they are dependent on Telkom Kenya for Internet backbone services. Not surprisingly, less than half of the 78 ISPs licensed in 2004 were operational.

Besides the ISPs, there are over 1,000 cybercafes countrywide providing Internet connectivity at increasingly affordable rates, in both rural and urban areas. This has been facilitated by the POPs established by JAMBONET in several parts of the county. JAMBONET has also pioneered provision of Freenet service connections to people with PCs and modems, the major beneficiaries being households and SMEs required to pay only for phone time. However, CCK discontinued this service in 2004, when ISPs complained that JAMBONET, the only supplier of Internet backbone services at the time, was giving them unfair competition in retail Internet services.

In response to competition from Internet mail, the Postal Corporation of Kenya (PCK) has diversified its service delivery to include Internet service through its post office network. As a result, the economic survey for 2004 shows that Internet services are available in 400 post offices, with firm plans to introduce such services in all the 890 post offices countrywide. The scope of Internet connectivity may be constrained by inadequate infrastructure and the lags involved in setting up of fixed-line infrastructure. Currently, infrastructure consists of two public international switches connected to Earth stations at Longonot and Kericho, and these could be the only ones for sometime. Similarly, connectivity within the region is poor because of lack of high capacity optic fibre on the East African coast.

3.2.2.3 Satellite communications

Satellite communication technology has been in use in East Africa for international gateway links. This is likely to increase with domestic link VSAT stations, as the technologies offer quick and cost-effective solutions for establishing links to and from remote areas where the provision of terrestrial infrastructure would be cumbersome, costly and time consuming. In the case of Kenya, VSAT facilities have been employed to establish external gateways, even in urban areas, because of the poor quality of services provided by Telkom and JamboNet. However, the licensing procedures have been very restrictive, requiring approval of CCK in consultation with Telkom/JAMBONET.

Most of those benefiting from VSAT connectivity have been commercial entities and embassies transacting businesses internationally. Several applications for authority to offer direct connection via VSAT have not been approved yet. Indeed, while a liberal and pro-competitive stance has been taken with respect to Internet and other telecommunications services, independent international gateway operators are permitted on a case-by-case basis (UNCTAD, 2005b). The South African multinational, Old Mutual, for example, which is planning to relocate its insurance and asset management back-office functions to Kenya, has been granted a private international gateway license (UNCTAD, 2005b). Regional satellite-based projects, which would have improved access and affordability but are yet to be implemented, include RASCOM, GMPS, and GSO Resources.

3.2.2.4 Other telecommunications value added services

E-services are somewhat operational in a number of sectors, notably tourism and financial services. Other sectors that could benefit immediately include education, health, and government operations. Following the liberalization of non-strategic portions of the telecommunications network in 1991 and the opening of the value added services market, the number of private telecommunications service providers, including SMEs, has increased considerably.

3.2.2.5 Data services

Data services connectivity has also improved markedly and is forecasted to expand considerably in the next few years (table 3.10). High-speed digital data circuit's service, KENSTREAM, was launched in 1996, while other data communication services operated by KENSAT and SAFARISAT have also been launched. Nevertheless, incentives to attract increased investment in data service should be considered.

Table 3.10. Data service connections in Kenya, 2000/01–2007/08

	Actual	Forecast						
	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Kenpac	525	530	540	550	570	580	600	620
Analogue circuits	2147	2600	3100	3800	4600	5600	6900	8400
Kenstream	454	660	990	1400	2000	2800	4000	6000
Telex	651	650	650	650	650	650	650	650
JamboNet & I-Xpress	30	50	70	90	120	150	200	280

Source: Draft 9th National Development Plan.

3.2.3 Cost and affordability

3.2.3.1 Telephony

The increase in mobile telephony services in the country has been accompanied by a decline in the cost of connection and handsets. The connection fees for Celtel, for example, have declined 44 per cent, from Kshs 1,490 to 990 currently. The price of calls has remained more or less constant (table 3.11), however, partly because of introduction of an excise tax on airtime in 2002. As table 3.11 shows, the cost of local fixed telephony services has gone up significantly, while those of long distance calls have fallen. The cost of international calls dropped much more. Thus, depending on the destination of the calls, data from Telkom Kenya shows that prices fell by 55–73 per cent, from \$2 to \$3.30 per minute in 2000 to \$0.90 in 2005.

Table 3.11. Telephone call charges in Kenya (Kshs per minute peak hours), 2002–2005

Year	Local calls			Distance calls 60–230 Km, TKL	Distance calls >230 Km, TKL	Calls to mobile, TKL	Calls to East Africa, TKL
	TKL	Safaricom	Celtel				
2002	5.60	28.50	28.20	20.00	25.00	27.00	44.00
2003	6.50	28.50	28.20	17.80	22.30	27.00	39.00
2004	7.40	28.50	28.20	17.40	17.40	27.00	46.00
2005	8.00			12.00	12.00	27.00	40.00

Source: Telkom, Central Bureau Statistics, CCK.

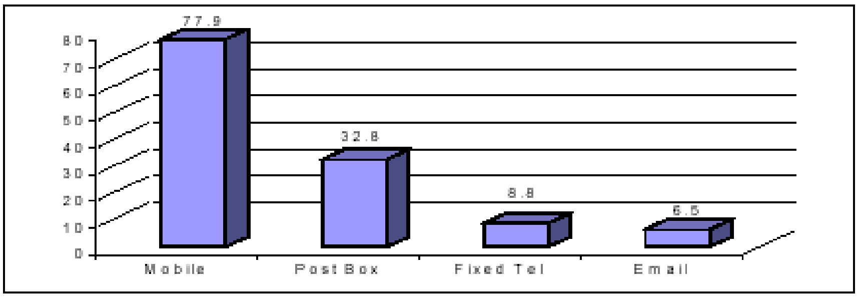
Relative to its neighbours, the cost of local and international telephone services in Kenya is competitive, while affordability of telecommunications services is slightly better among Kenyans as indicated by, for instance, the ratio of fixed telephone subscription fees in per capita income (table 3.12). Affordability of fixed telephony services in Kenya has, moreover, improved from 12.1 per cent in 2000 to 7.6 percent by 2003 due to increasing competition. Close to 80 per cent of telephony use among Kenyans is now mobile, and less than 10 per cent is fixed telephony (figure 3.3). On average, moreover, Kenyans spend Kshs 600 per month on mobile telephony, compared with only Kshs 110 on fixed telephony, Kshs 419 on e-mail, Kshs 362 on Internet, and Kshs 55 on post mail (CCK/IDRC, 2004).

Table 3.12. Cost of telecommunications services in Kenya relative to neighbouring countries

	Kenya	United Rep. of Tanzania	Uganda	South Africa
Cost of 3 minute call to the United States ($)	3.75	5.28	3.51	0.58
Local cellular call ($)	0.2	0.19	0.25	0.27
Subscription expenses for fixed service as % of per capita GDP, 2000[37]	12.1	18.8	31.1	-

Source: UNCTAD (2005b); EAC Regulators; Telkom Kenya Ltd.

Figure 3.3. Means of communication used by Kenyans



Source: CCK/IDRC (2004).

3.2.3.2 Internet services

The tariffs for Internet connectivity, even the backbone services that have so far been supplied by Telkom Kenya alone, have also fallen drastically following reforms and therefore competition (table 3.13), thereby improving affordability. The international connectivity charges have not changed much in the last five years, however, because of the Telkom Kenya monopoly. This situation is likely to change, with considerable benefits to consumers in the form of reduced cost and improved quality, since TKL's monopoly ended in September 2004.

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[37] These are very high compared to 0.7 for the Untied States the same year. Since 2000, the ratio for Kenya had fallen to 8.7 by 2002 and 7.6 by 2003.

Table 3.13. Tariffs for various forms of Internet connectivity ($/month), 2000/01–2004/05

	2000/01	2002/03	2004/05
Local leased lines			
Analogue		91.39	
Digital lines up to 64 Kbps		182.28	
Digital lines up to 128 Kbps		264.29	
Digital lines up to 256 Kbps		364.54	
International leased lines			
Digital lines up to 64 Kbps	8,200		6,150
Digital lines up to 128 Kbps	11,597		8,697.75
Digital lines up to 256 Kbps	16,400		12,300
Internet backbone			
Digital lines up to 64 Kbps	4,500	1,687.50	521.88
Digital lines up to 128 Kbps	6,366	2,386.50	1,225.77
Digital lines up to 256 Kbps	9,000	3,375.00	1,740.11
Digital lines up to 512 Kbps	12,728	4,773.00	2,719.90

Source: Telkom Kenya.

The rapid growth in the number of ISPs has improved the quality of service and reduced its cost tremendously. While the cost of Internet services was as high as Kshs 5–10 per minute from 1998 to 2000, for instance, this has fallen to Kshs 0.50–1 currently.

3.2.4 Efficiency

Prior to 1998/99, there were very limited modes of communication in Kenya, mainly fixed telephone, fax and telex. All were public, with poor quality and low coverage. There were constant complaints from all sectors of the economy about the quality, cost and availability of communications services (table 3.14).

Table 3.14. Relative performance of Kenya on investor perceptions of telecommunications services

	Kenya	United Rep. of Tanzania	Uganda	South Africa
Investors' negative perception of telephones, 2000	64.5	13.9	13.4	5.0
Investors' negative perception of telecommunications, 2003	44.1	11.6	5.2	-

Source: UNCTAD (2005b).

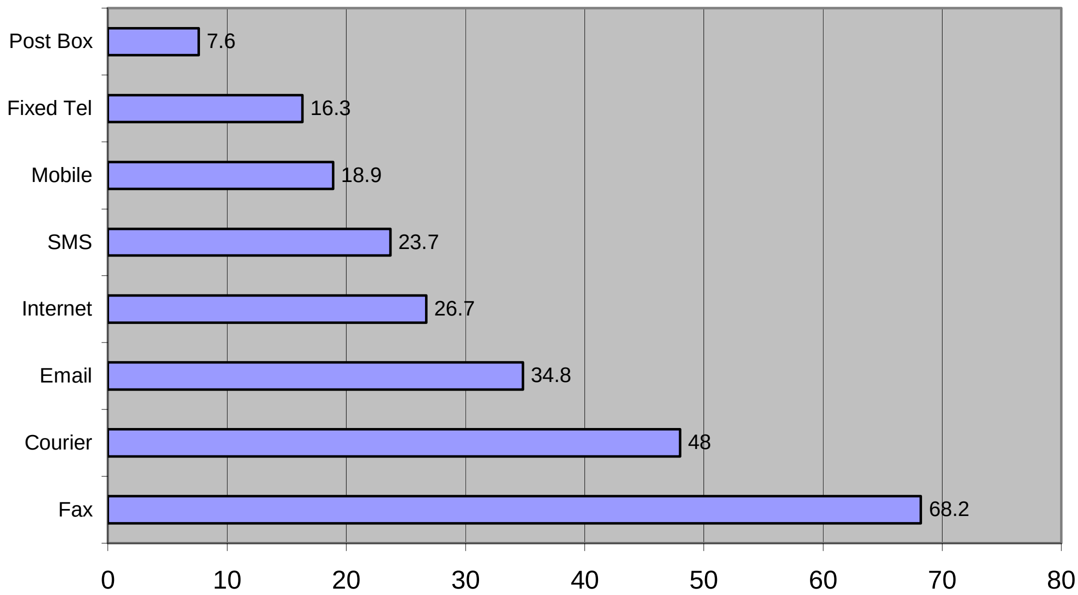
Following telecommunications reforms at the end of the 1990s, the diversity of service providers grew considerably, thereby offering a wide range of telecommunications options for users. Local businesses picked up in sectors that did not require heavy investment or heavy training. These included distribution of Internet services through cybercafes, dealerships in terminal equipment and maintenance, and registration of professionals to provide technical support services. In addition, following the end of TKL's monopoly in September 2004, the number of players in the critical area of Internet gateway service provision increased by four in 2004/05.

The rapid increase in the number and diversity of service providers has had a tremendous impact on the efficiency of telecommunications services in the country. For example, Internet and mobile telephony services opened new horizons of faster and cheaper communication. Even outsourcing or back-office operations have entered the Kenyan telecommunications market, with the recent establishment of the first call centre. Not surprisingly, the investor perception of the quality of telecommunications services had already improved as early as 2003, although this was way below the perception of the services in Uganda and the United Republic of Tanzania (table 3.14).

The interconnectivity of the mobile telephony into international roaming service networks has, moreover, made it easier for travelers to maintain contact and transact business while traveling. Further, the multi-functioning of the new generation of GSM mobiles accommodates Internet transactions, thus reducing the need for computers. As a consequence, the media, for instance, now transmits news items and other stories instantaneously to the Internet via the mobile phone.

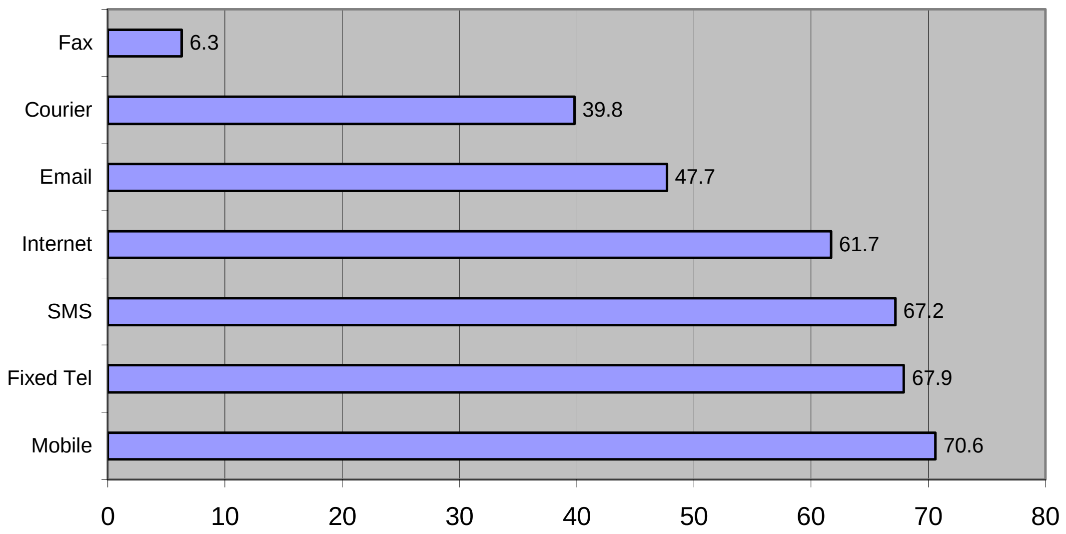
The transformations in the telecommunications sector have considerably improved efficiency in the business and social sectors, where technology now plays a central role in service delivery. ATMs and plastic money have revolutionized operations in the financial sector, and it is now convenient to procure a number of services such as tourism, payment of taxes, and trade online. Indeed, the new modes of communication such as mobile telephone, SMS, Internet and e-mail have overtaken the use of fixed-line telephones for business transactions (figure 3.4). Even in social usage, fixed telephony has been overtaken by these new modes of communication (figure 3.5).

Figure 3.4. Relative use of different modes of communication for outgoing business transactions in Kenya



Source: CCK/IDRC, 2004.

Figure 3.5. Relative use of different modes of communication for outgoing social transactions in Kenya



Source: CCK/IDRC, 2004.

3.2.5 Trade in telecommunications equipment and services

Kenya is a net importer of telecommunications equipment, apparatus and accessories. In 2002, for instance, the country's imports of this equipment were valued at Kshs 9.63 billion, compared to exports valued at only Kshs 27 million. The main imports were:

- Automatic data processing machines (Kshs 2.89 billion);
- Assembled or partly assembled mobile phones (Kshs 1.87 billion);
- Digital line apparatus (Kshs 1.73 billion); and
- Parts and accessories for use in telecommunications and sound reproducing apparatus (Kshs 0.90 billion).

In the case of telecommunications services, Kenya's exports are very small. In 2000, for example, the country exported communication services worth $22 million or 2.2 per cent of the total services exports that year. The main reason for this is the many years under which the sector was constrained by a restrictive regulatory environment. This environment hampered the sector's ability to develop its export potential. Although recent liberalization and privatization have made significant improvement in telecommunications capacity, there is still weak domestic supply capacity, especially due to underdeveloped basic infrastructure. Lack of an optic fibre network infrastructure in the East African coast also continues to hamper Kenya's ability to exploit its export potential.

The level of Kenya's reliance on imported telecommunications services has not been measured comprehensively. However, such imports continue to be important considering the strong presence of foreign capital in the sector. As noted already, for example, Vodafone of the United Kingdom owns 40 per cent of the equity in Kenya's largest mobile telephone operator, while Celtel of the Netherlands owns 40 per cent of the other operator. More evidence on the role foreign service providers play in the Kenyan telecommunications sector will emerge in section 3.5.

3.2.6 Employment

The Kenyan labour force is well educated and fluent in English, and therefore requires minimal training for the application of ICT. The country's overall literacy rate is 78 per cent, with that of males being even higher. Records of the two mobile companies show that they have directly created more than 1,000 new jobs. The figures for indirect employment are difficult to calculate but are evidently substantial. These jobs are in (a) dealership distributions and agency business; (b) the many outlets that retail telecommunications products and services such as handsets, accessories and airtime; (c) support services; (d) computer assembly; and (e) repair/maintenance services for hardware and software. In community phones (*Simu ya Jamii*), moreover, estimates from the Nairobi City Council indicate that there are about 10,000 such operators in the city alone.

The overall net employment impact of reforms in the telecommunications sector is not easy to judge, however, as Telkom Kenya is expected to retrench 11,000–14,000 employees. From the trend so far, it seems that the net impact will be positive, however, as the potential for more jobs in the sector is great.

3.3 Relative status of telecommunications policy and services in the East African Community

During the colonial period and the first stint of the EAC (1966–1977), telecommunications services were delivered jointly within East Africa. Even after the collapse of the EAC in 1977, the newly established national postal and telecommunications corporations maintained some coordination. In general terms, however, the three East African countries subsequently pursued telecommunications reforms at different speeds and depth, with Kenya relatively late in the liberalization of mobile telephony, but having relatively deeper reforms in overall terms, as summarized in table 3.15.

Re-establishment of the EAC in 2000 provided new impetus for regional coordination. With the establishment of the East African Customs Union in January 2005 and a roadmap towards a Common Market by 2007, prospects of harmonization and unification of the infrastructure, services and regulatory frameworks are eminent.

Table 3.15. Summary of policy and regulatory status for EAC member countries

Policy/regulatory issue	Kenya	Uganda	Utd. Rep. of Tanzania
Independent regulator	Communications Commission of Kenya	Uganda Communications Commission	Tanzania Communications Commission. Became TCRA under 2003 Act of 1st November 2003
Liberalization schedule	Local: 2004; National long distance: 2004; International: 2004; Mobile: 2000	Local: 2004; National Long Distance: 2004; International: 2005; Mobile: 1998	Local: 2005; National Long Distance: 2005; International: 2005; Mobile: 1995
ICT policy/vision	Promulgated 2001, new draft June 2003	Promulgated 2001	Under preparation
Local services	Partial competition monopoly	Competition	Monopoly
National long distance	Monopoly	Competition	Monopoly
East African	Monopoly	Competition	Monopoly
International	Monopoly	Competition	Monopoly
Payphone services	Monopoly	Duopoly	Liberalized
ISP	Competition	Competition	Competition
ISP gateway	Monopoly	Partial competition	Monopoly

Internet Cafe/MCTs	Full competition but licensed	Full competition	Full competition
Data	Full competition	Full competition	Monopoly
Mobile telephone services	Full competition, 2 licensed	Full competition, 3 licensed	Full competition, 4 licensed
Private VSAT licensing	Yes	Yes	Yes
GMPCS	Inmarsat	Inmarsat Thuraya	Inmarsat, Thuraya soon
FWA: WLL	Competition	Competition	Competition
Terminal equipment trade	Full competition	Full competition	Full competition
Type approval	Regulator	Regulator	Regulator
Public VoIP	Not permitted	Not permitted	Not permitted
Universal service fund	Being instituted	Yes, operational	Yes, being instituted
Universal service obligation	Yes, posts, telecoms and cellular	Yes, telecoms and posts	Yes, telecoms and posts
Tariff regulation	Yes, posts and telecoms	Yes, enabled	Yes
Tribunal	Instituted	Instituted	Instituted

Source: EAC secretariat and Partner State telecommunications regulators.

Already, regulators in the three countries have set a regional forum to look into technical, legal, management and related communication regulations. Harmonization and integration of the telecommunications services in the region will create better opportunities for both local and foreign private sector investments. With respect to the status of telecommunications services in the region, connectivity and usage are considerably higher in Kenya, followed by Uganda, although the level of competition in fixed and mobile telephony is lower in Kenya (table 3.16). The number of international VSAT and public data network operators is also considerably smaller in Kenya, implying that there is still substantial scope for further liberalization and the accompanying benefits in the country.

Table 3.16. Comparative telecommunications status in East Africa, June 2003

Type of service	**Kenya**	**United Rep. of Tanzania**	**Uganda**
Fixed-line operators	1	2	2
Fixed-line subscribers	331,000	60,000	151,000
Mobile cellular operators	2	3	4
Mobile cellular subscribers	1,600,000	600,000	647,000
Internet service providers	65	17	23
Internet hosts	2,702	293	1,478
Internet users	1,300,000	60,000	300,000
Estimated number of PCs	175,000	70,000	120,000
International VSAT network operators	1	8	6
Public data network operators	4	N/A	16

Source: East African Regulators, and ITU/CCK 3rd Pre-bidders Conference, Nairobi, 24 June 2003.

Whereas Kenya's average telephone costs are comparable to those of middle- and high-income countries, the country lags substantially behind in telephone connectivity and use (table 3.17).

Table 3.17. Status of telecommunications in Kenya relative to low-, middle- and high-income countries

Indicator	Kenya			Low-income countries			Middle-income countries			High-income countries		
	1990	1999	2003	1990	1999	2003	1990	1999	2003	1990	1999	2003
Telephone main lines per 1,000 people	8	10	10	6	26	32	46	121	180	420	583	562
Telephone main lines per 1,000 people in the main city	-	71	-	-	125	-	-	293	-	-	-	-
Telephone main lines per 20 employees	-	20	-	-	72	-	-	166	-	-	230	-
Waiting list for fixed telephone connection, thousands		113			7,728			28,594			64	
Waiting time for fixed telephone connection, years		10			6			1			0	
Cost of local call for fixed telephone, $ per 3 min.		0.05			0.06			0.05			0.1	
Cost of call to United States, $ per 3 min.		11.2			-			4.4			1.8	
Mobile phones per 1,000 people	0	1	50	0	3	24	0	55	224	9	377	710
Internet users per 1,000 people	0	-	-	0	-	14	0	-	77	3	-	477

Source: UNDP (2005); other sources.

In spite of the monopoly situation, Telkom Kenya and its predecessor have sustained low prices/tariffs mainly because of government subventions provided in recognition of the critical role telecommunications play in the totality of economic activities. In addition, subscribers to the telecommunications services had a threshold to sustain telecommunications activities. Further, the telecommunications services were continuously modernized and automated, making it possible for customers to use services without relying on operators. More important, however, is the fact that the private business community was large and had a high service usage, which helped to keep tariffs relatively low.

3.4 Kenya's GATS commitments in telecommunications

3.4.1 The commitments

Under the GATS framework, Kenya has since 1998 made commitments in all five areas of telecommunications services:

- Fixed telephony;
- Mobile telephony;
- Value added services;
- Internet; and
- Audio-visual services.

The specific services committed include telecommunications services except video and audio broadcast, voice telephony services, facsimile services, packet swift data transmission services, telegraph services, e-mail and electronic data interchange.

With these commitments, however, there are limitations especially on market access. These limitations include (a) foreign equity limits; (b) public monopoly over basic telecommunications (often for specified periods); (c) prohibition of international callback services; (d) movement of natural persons is unbound except for managers and other expert staff; (e) commercial presence in audiovisual services, motion picture and videotape production (except distribution services) is unbound; and (f) cross-border trade for motion picture projection is unbound.

The country has implemented all the tenets of the telecommunications reference paper (WTO, 24 April 1996) (box 1) to varying degrees, as dictated by its capacity and competence.

Box 1: GATS Reference Paper on Telecommunications

Telecommunications are among the most dynamic service sectors covered by the GATS. An important element of telecommunication reform in the WTO is the Reference Paper (RP), which covers areas such as competition safeguards, interconnection guarantees and transparency in licensing. Among other salient features, the RP:

- Provides rules to be followed by government regulation of major suppliers, that is, suppliers that control essential facilities that for economic and/or technical reasons cannot be duplicated.
- Mandates governments to take measures to prevent major suppliers from using anticompetitive practices such as cross-subsidization, use of information obtained from competitors, and withholding of information from competitors.
- Mandates governments to ensure all competitors have adequate interconnection with major suppliers, in a nondiscriminatory manner and at a reasonable price.
- Requires the provision of services to be unbundled so that no supplier is compelled to pay for services that are not needed.
- Allows governments to introduce universal service provisions as long as they are administered in a transparent, nondiscriminatory and competitively neutral manner and so long as they are not more burdensome than necessary.
- Requires that the regulatory body be separate from the actual suppliers and be able to ensure impartial procedures vis-a-vis all market participants.
- Requires all member governments to allocate and use scarce resources (including frequencies) in a timely, transparent and nondiscriminatory manner.

Immediately after KP&TC was restructured in 1999, CCK was established as the independent regulator. It has since performed its services impartially in spite of TKL's dominance and monopoly status in fixed-line telephony and Internet backbone service. CCK has intervened on a number of occasions when Telkom has attempted to take advantage of its dominance, for example, competing with ISPs when it monopolized Internet backbone services and could therefore out-price the competitors. CCK intervened also when the two mobile service providers could not work out realistic interconnection fees for their services. In addition, CCK has published on its website the licensing criteria, terms and conditions of accessing services including reasons for denial, transparency in interconnection arrangements and modalities of dispute settlement.

The current capacity of CCK may not be adequate to argue for any case at the WTO level. It may therefore be prudent for detailed studies to be undertaken before further commitments are made to make sure that safeguards that are not contestable are put in place.

In the licensing of operators in both mobile and fixed-line telephony services, Kenya obligates them to universal service access, an objective that is enhanced in the Draft ICT Policy Paper of 2004.

3.4.2 Impact of the commitments

The bold policy reforms embraced in the Kenyan telecommunications sector since 1998/99 largely coincided with the country's commitments in telecommunications under GATS. These reforms have brought considerable benefits to the economy by way of improved service availability, accessibility, affordability and efficiency. These effects or impacts were discussed in detail in section 3.2 and should also be viewed as impacts of GATS commitments. To highlight a few:

- Telephone connectivity (both fixed and mobile but excluding Internet telephony services) increased from 10.4 lines/1,000 people in 1999 to 84.4 lines/1,000 in 2004.
- Internet connectivity increased from 19.87/1,000 people in 2000 to 46.61/1,000 in 2004.
- Connection fees for the whole range of services have fallen as competition has increased. For example, Kencell (Celtel) connection fees decreased from Kshs 1490 in 2000 to Kshs 990 in 2005. Tariffs for Internet connectivity have also fallen considerably.
- The cost of most services has also dropped. With competition from mobile service providers, for example, Telkom Kenya Ltd. reduced its local long distance prices from Kshs 20 in 2000 to Kshs 12 in 2005. TKL charges for international calls have also dropped from $2.50/minute in 2000 to $0.90/minute in 2005 for calls into Europe, North America and non-COMESA countries.
- Efficiency of service delivery on timeliness, cost-effectiveness and application of technology also improved considerably following liberalization.
- Other benefits the telecommunications reforms have brought include the creation of new economic activities, generation of employment and income, and contribution to government revenue. One of the mobile telephone operators, Safaricom, for example, has paid over Kshs 30 billion since it started operations, and has become one of the country's leading taxpayers.

More evidence of the impact and effects GATS commitments and telecommunications liberalization in general have had on the sector and the rest of the economy is presented in section 3.5.

3.4.3 Requests for further commitments

Besides the commitments Kenya has already made within GATS, the country has received a number of requests for further commitments on market access and clarifications. The requests were received as part of the ongoing GATS 2000 negotiations that are yet to be concluded. The United States, European Commission and Norway have made requests for (a) commitments in communication express delivery; (b) commitments that reflect market opening in audio-visual; (c) explanation and/or removal of restrictions on international callbacks, Telkom monopoly, satellite based services, mobile services, and the limitation of foreign equity participation to a maximum of 30 per cent; and (d) full commitments in basic telecommunications and value added services. The deepening of liberalization in the telecommunications sector undertaken in September 2004 to some extent addressed these requests. In addition, the country is still making consultations so as to respond to the requests.

In order to attract foreign investment and technology into the country's telecommunications services, there is need to deepen reforms by making further commitments within GATS, particularly for those services that Kenya does not have adequate and sufficient capacity to undertake. These include basic telecommunications and satellite-based services. For most of the value added services, however, the country has or could quickly build supply capacity. Requests for further commitments on these should therefore be considered case by case against the existing or potential local supply capacity. There are several studies being carried out, to support Economic Partnership Agreement (EPA) negotiations with the European Commission, which should be of particular usefulness for this purpose.

3.5 Linkages with other economic sectors

With considerable liberalization of Kenya's telecommunications services sector in the last five or so years, the sector has become vibrant and created notable linkages with the rest of the economy.

3.5.1 Development of computer and related services

Development of computers and rental services in Kenya has hardly begun because of the monopoly granted to Telkom Kenya, until September 2004, to provide the country's only Internet backbone services and international telecommunications services. The government strategy at that time was for Telkom Kenya to be privatized by 2001 with the strategic partner injecting the required capital, technology and management skills to enable the corporation to compete internationally. The planned privatization failed and the corporation has since continued to provide poor services through an outdated network. The only segment of the market that was partially liberalized was the use VSAT by private corporations for data transmission only, despite the fact that voice could also be used over VSAT. The corporations that benefited from this include banks that use VSAT to transmit data to run the ATM machines and other computing services. A South African insurance company with a subsidiary in Kenya has also been granted a VSAT license, as mentioned earlier.

In spite of policy and infrastructure constraints, the high and growing demand for ICT products and services has stimulated development of new business in C&CR services besides assembly of computers and telecommunications equipment. From the Yellow Pages 2004 and Telkom Kenya Directorate (Edition 12), for example, there are some 30 to 50 computer assemblers, over 75 computer consultants, 50 to 75 computer hardware maintenance firms, and over 200 programmer/software service providers in Nairobi alone.[38] In addition, international computer and software developers have established resident representatives as outlets to market their products and services.

The Kenyan business entrepreneurs in these sectors are predominantly SMEs or professionals who specialize in providing the services in the COMESA region. Because this activity is relatively new, modalities for statistical data capture have not been put in place. From informal estimates based on interviews of computer assemblers and results of Ministry of Finance consultancy study, domestic assemblers produce less than 10 per cent of the national requirements, with the rest

[38] Obviously, there are many other firms or consultants that are not included in these directories.

being imported. Professionals as individuals or SMEs in an informal set predominantly provide consultancy services on hardware installation, systems analysis, designs, and maintenance and programming. Larger establishments obtain similar services from more established companies, which in most cases are branches of multinationals.

Data processing services remain basically institution-based, with institutions that employ staff on a full-time basis and train them to perform such functions in house. However, in a limited number of cases, databases so generated (e.g. census data or household budget surveys) mainly from the public sector are shared, with authority from the Government, with other (international) research institutions for purposes of further analysis. Subcontracting of data processing services has not taken root in the country yet, although bureaus and cybercafes provide such services particularly to researchers in a limited way.

Currently, databases operate on a stand-alone basis. However, with the evolving e-government services, there is a likelihood of interrogating databases for purposes of cross-referencing for purposes of speeding up service delivery. For example, the Kenya Revenue Authority (KRA) maintains separate and independent databases of taxpayers for income tax, VAT, customs and driver's licenses. In the process, the same taxpayer is allocated different identification numbers and has to go through long, tedious and bureaucratic processes. Similarly, the registrar of persons maintains a database on births/deaths and IDs issued which would be a good source for drivers' licenses and other related governance issues.

Institutionalized telecommunications training in universities and tertiary colleges has picked up. With such training and an improved and predictable domestic investment environment, more domestic production is anticipated.

3.5.2 Offshore services

In general, offshoring opens opportunities for business process outsourcing. It provides an opportunity for countries to benefit from globalization, since the most efficient suppliers benefit, regardless of their status, size and location supply services. In other words, with off-shoring the only determinants of the service supplier chosen become quality, price competitiveness and timeliness of delivery. Furthermore, offshoring provides opportunity for foreign labour (such as Kenya's) to participate in areas where immigration restrictions prevail (such as producing for the United States market without the labour having to move there). Availability of information on the Web facilitates outsourcing. In any case, developing countries stand to benefit in cases where they have the relevant skills to perform tedious back-office operations, as in Kenya. There is also the opportunity for technology transfer arising from production of standardized services.

There is a great potential for Kenya to develop offshore services such as call centres, data processing and data storage. The country has a substantial number of professionals working under professional associations, who could be mobilized at short notice and with minimal relevant ICT training to provide back-office operations or deliver competitive outsourced services. Other offshore services with potential in the country include research and development, intellectual property rights and trademark registration, accounts/audits, medical, education, equity analysis, software product management and architecture, among others.

For this potential to be realized, however, technical barriers in terms of infrastructure have to be overcome, including investment in fibre optic and marine cable systems. In the short run, the use of

VSAT can be expanded, but it has its limitation in terms of clarity and delayed reception. Other potential barriers that have to be addressed include (a) lack of resources for the required investment; (b) lack of ICT, policy, legal, regulatory and institutional frameworks; (c) confidentiality, integrity, morality and security of data and information owing to the growing problem of cyber crime; and (d) inadequacy of cutting-edge manpower resources to cope with the ever-changing telecommunications technology. Another barrier is the fact that e-commerce reduces customs taxes, which many developing countries heavily rely on.

3.5.3 Emergence of ICT-enabled services segments

Telecommunications is an economic infrastructure that serves other socio-economic sectors, including commerce, education, health delivery, rural development, modernization of management, and governance, among others. Globally, for instance, the bulk of business and development is being delivered via the Web/Internet. Consequently, e-enabled transactions have emerged to ensure competitiveness, efficiency, accessibility and productivity. Indeed, technological advances in ICTs have increased tradability of many services. E-service delivery started with the private sector, with pioneer activities in finance and banking, trade, education and tourism. The latest entrant to e-service is the Government, although this is being constrained by the limited ICT literacy capacity of public sector employees.

The relative potential of exploiting ICT-enabled activities in the country can be evaluated on the basis of accessibility to telephone lines (tables 3.18 and 3.19).

Table 3.18. Distribution of fixed telephone lines per sector in Kenya, 2002

Sector	No. of Lines	Percentage	Sector	No. of Lines	Percentage
Agriculture	2,822	0.88	Operator (TKL)	9,965	3.11
Bureau	1,267	0.40	Others	11,860	3.70
Commercial	66,656	20.79	Parastatal	6,858	2.14
Educational	6,026	1.88	Payphones	9,562	2.98
Financial institutions	9,045	2.82	Personal	159,155	49.64
Government	13,392	4.18	Professional	6,097	1.90
Health	3,670	1.14	SACCOs	1,050	0.33
International	3,091	0.96	SME	2,023	0.63
NGO	8,056	2.51	**Total**	**320,595**	

Source: Ministry of Finance and Planning (2002); Telkom Kenya; CCK; and National Development Plans.

Table 3.19. Distribution of fixed telephone lines per stakeholder category in Kenya, 2002

Stakeholder Category	No. of Lines	Percent age
Corporate	45,466	14
Government Institutions	27,283	8
SMEs	109,122	33
Individuals	145,755	44
Total	**327,626**	99

Source: Telkom Kenya; CCK; and National Development Plans.

The commercial sector, SMEs and individuals have the bulk of the country's telephone lines and therefore relatively greater potential of developing e-enabled segments. The corporate sector has made substantial headway while SMEs may be lacking the necessary skills to exploit opportunities in the ICT sector. It should be noted, however, that mobile telephony has substantially enabled SMEs, especially briefcase businesses that do not have physical offices, to advertise their services and to be contacted easily.

The agriculture sector is increasingly using mobile telecommunications in marketing their products, by contacting many buyers for purposes of price comparisons and deals. A United States Agency for International Development (USAID)-sponsored project, Kenya Agricultural Commodity Exchange (KACE), avails regional information on markets and prices to maize farmers for purposes of trade in the preferential market. The small number of telephone lines available to the sector is, however, a major bottleneck, which is increasingly being eased by mobile telephony. While there were only about 15,000 mobile phone subscribers in June 1999, the number is about 5 million currently and is still increasing rapidly. More importantly, the mobile telephone network covers more than 80 per cent of the country and there are more than 5,000 community pay phones, which can be powered by solar power or car batteries and are therefore particularly suitable for rural areas without electricity. This has considerably increased access for the poor.

Financial sector developments span a variety of transactions, which include credit cards to serve local and international markets, branchless banking, and ATM services, which now provide multi-bank access. ATM services have decongested banks because customers get 24-hour service in many parts of the country, as opposed to the previous arrangements, where one had to be serviced from one's own bank and branch. Furthermore, the ATM services allow for the settlement of utility bills without necessarily joining long queues. In addition, transactions can also be done through the convenience of the mobile anywhere at any time, provided the network is in place.

In the tourism sector, which is predominantly operated by the private sector, ICT plays a crucial role in marketing, reservation and transportation. Currently, for example, the Kenyan visa application forms can be downloaded online as opposed to the previous practice of physically collecting the forms from the embassies. The bulk of the local players now maintain websites to transact their businesses, including online payments. The net result of this e-enablement has included (a) attraction of more tourists and other visitors; (b) reduction in the costs of international tourism promotion; (c) building up of tourism-related databases for destinations and facilities; (d) provision of tourism-related information that facilitates investment in tourism products; and (e) management of wildlife, national parks and game reserves.

In the education sector, e-learning has made it possible for students to take distance learning and graduate with foreign diplomas and increased accessibility of education materials at no or minimal costs, thus ensuring that students have standard training materials required for global labour markets. In collaboration with USAID, the Government has established KENET (Kenya Education Network), which now links 17 institutions of higher learning. It is the Government's intention to extend this network to all schools in the country and to promote links to similar networks in the rest of Africa. The Virtual University at Kenyatta University and KENET has taken e-learning a notch higher. It is possible now to connect schools, universities and research centres to national and international distance education facilities, databases and other facilities, and extend the reach of education facilities to the community level at a fraction of the previous costs.

The Government is a latecomer in the provision and utilization of e-enabled services. Now, however, it foresees benefits of e-Government in:

- Improved efficiency and effectiveness of resource utilization through better collaboration of government agencies and reduction in duplication of efforts.
- Timely information and delivery of Government services.

- Reduced transaction costs for Government, citizens and the private sector through provision of goods and services electronically.
- The establishment of a forum for citizens to participate in government activities.

Some of the government services lined up for e-delivery include (a) revenue/tax collection by KRA and related agencies; (b) maintenance of databases and registries in lands, local authorities, motor vehicle department, births/deaths registration; and (c) procurement. Besides delivering the above benefits, these initiatives will improve governance.

3.5.4 The role of SMEs in telecommunications and ICT services

The Kenyan economy is predominantly smallholder, in both agriculture and business, operating in a liberalized environment. In a variety of products and services, moderately small investments and outlays are involved. Not surprisingly, therefore, about 33 per cent of the country's fixed telephone lines are connected for SMEs (table 3.18), giving them considerable potential to use the Internet. The divisibility of ICT products and services makes it possible to deliver the services to the population through SMEs. SME involvement is beneficial to the extent that their outreach and flexibility to deliver services to the underserved is bigger than that of well-established and multinational companies. For example, while it does not make business sense for big investors to invest in Internet business on account of the bulk of the information on Internet being free, SMEs can put in moderate investments and charge small access fees, which are affordable by the bulk of the population. Cybercafes, most of which are operated by SMEs, create wider opportunities for ordinary people to transact business on the Internet at a small fee without having to own a computer or pay monthly telephone bills. The youth also have access to e-services, thereby placing them more or less on par with their counterparts anywhere else in the world.

Other factors that make telecommunications services feasible for SMEs include the following:

- Ease of diversifying existing arrangements to incorporate ICT. For example, bureau services obtain high value on incorporation of ICT.
- Licensing arrangements allow partnerships between SMEs and bigger investors.
- Availability of Digital Subscriber Line technology for wider connectivity. The SMEs would create the needed synergies for the transfer of technology and benchmarking against internationally accepted standards.
- SMEs can pilot new initiatives with a view to expanding successes to the rest of the economy.

Some of the e-businesses that are suitable for SMEs include:

- Equipment vending, particularly sale of telecommunications equipment at retail level in the rural areas.
- Delivery of training and capacity-building programmes, which in the majority of cases require moderate facilities affordable by SMEs.

3.6 Constraints and opportunities for future development

3.6.1 Are telecommunications services meeting policy objectives?

As noted in the current economic blueprint *Economic Recovery Strategy for Wealth and Employment Creation (2003–2007),* the "broad objective of the telecommunications sector is to create a seamless, efficient and cost effective telecommunications service for business and social interactions" through an effective national ICT policy. This policy remained under preparation for a number of years, but was eventually published in February 2005 for stakeholder scrutiny. The new policy addresses many pertinent issues in telecommunications, as many stakeholder groups made contributions to its development.

To ensure that telecommunications services reach all unserved and underserved areas at affordable rates, the Government made appropriate resolutions and put in place licensing procedures to ensure compliance from all market players. The service provider licenses include targets to facilitate roll out plans countrywide. Related to this, the Government's overall objective with respect to the telecommunications sector is its optimal contribution to economic development through the availability of efficient, reliable and affordable communications services throughout the country. More specifically, the policy targets include:

- Improvement of service penetration in the rural areas from the present 0.16 lines to 5 lines per 100 people by the year 2015; and
- Improvement of service penetration in the urban areas from the present 4 lines to 20 lines per 100 people by the year 2015.

These targets translate into installation of 1.5 million fixed lines in rural areas and 2.4 million fixed lines in urban areas. At an estimated average cost of about $1,500 per line, the total investment required over the 15 years period is $5.85 billion or $390 million annually. The policy guidelines proposed new initiatives to attract this enormous capital.

The universal access targets have not been achieved yet but the process is underway, with the mobile services providers already covering over 60 per cent of the population and over 80 per cent of the country. As they continue to roll out their services, the remaining population centres will be covered. Although the Government's main policy is that of universal access, capacity and resource constraints forced it to focus on Multipurpose Community Telecentres in the interim. While the mobile telephone operators have surpassed their performance targets set by the regulator, fixed telephony targets have not been achieved, as pointed out earlier.

Telecommunications services in Kenya are thus largely meeting the Government's policy targets, although various challenges still stand in the way.

3.6.2 Challenges

Despite the recent boom in the communications sector following liberalization and privatization reforms, the Government recognizes the existence of various challenges, which must be addressed to harness the full developmental potential of the ICT sector. These are listed below.

3.6.2.1 Legal, regulatory and policy bottlenecks

The telecommunications sector in Kenya has only one regulator, the Communications Commission of Kenya (CCK). Before CCK was established, KP&TC did both regulatory and operational functions. CCK has carried out its functions in an exemplary manner. The major challenge has been the policy limitations that have held back the growth of the sector. These include the five-year exclusivity granted to Telkom Kenya, frequent policy reversals, especially with respect to the privatization of Telkom Kenya, problems with enforcement of legal provisions in relation to equity and penalties for non-compliance, and the restrictions on maximum equity participation by foreign investors that have at times delayed investments as local co-investors have lacked adequate resources[39]. As noted in the EAC Preliminary Study on Regional Communication Strategy (EAC secretariat, 2004), CCK, like many other regulators in the region, often faces difficulties in enforcing obligations and penalties on operators particularly when the operator is a monopoly with high government shareholding. Being subject to political decisions weakens regulatory frameworks. Enforcement of regulatory mandate is, further, made difficult by the absence of an ICT national policy.

Currently, moreover, ICT issues are still considered under various legislations including the Science and Technology Act of 1990, the Kenya Broadcasting Act of 1990 and the Kenya Communications Act of 1998, which are inadequate in dealing with emerging issues such as liberalization in the broadcasting sector, electronic commerce and e-Government. There is no legal and regulatory framework for execution of e-business.

In spite of substantial improvement in the legal and regulatory environment in the country, therefore, the business environment is not adequately stable and conducive to stimulate investors to take advantage of the market opportunities ushered in by liberalization of the telecommunications sector and the wider regional market arising from the East African Customs Union. However, it is anticipated that the telecommunications legal framework under the East African Customs Union will be harmonized and unified for better service delivery.

3.6.2.2 High tariffs and poor services

Tariffs in the country and the region are still high, which is exacerbated by poor and unreliable services. The 10 per cent tax on airtime has contributed to the problem of high tariffs, making even mobile telephone services out of reach for the poor. Under these circumstances and high poverty incidence, it is a real challenge to ensure price affordability, particularly in the rural setting, even where Multi-purpose Community Telecoms have sprung up. In addition to this, the tariff structures stifle technological advances and development.

3.6.2.3 Inadequate infrastructure

Telecommunications infrastructure is still largely inadequate, both locally and regionally, especially in the rural areas, leading to a serious rural–urban communications gap. The East African coastline remains the only portion without high capacity optic fibre to improve connectivity within the region and the rest of the world. Satellite communication services and other new technologies should be exploited for purposes of improving accessibility and affordability. Furthermore, there is need to improve the Lake Victoria communication systems.

[39] The third mobile phone operator in Kenya has been faced with this problem, which has not only delayed its operations but also led to an expensive lawsuit.

3.6.2.4 Technical capacity constraints

Technical capacity constraints are still considerable, especially in the public sector and with respect to women. Technical skills and staff capacity constraints hamper the usage and applications of new technologies coming into the market.

3.6.2.5 Lack of a universal service fund

Lack of a universal service fund has constrained achievement of universal service, particularly in the rural areas.

3.6.3 Opportunities

Government service delivery mechanisms should employ e-assisted technology in order to improve service delivery. Services that could immediately benefit from such services include e-business/e-commerce, e-learning/tele-education, e-health/telemedicine, and e-governance. In telemedicine, for example, ICT has the potential to (a) enhance health administration and management through medical info-systems; (b) provide linkages of health centres, delivery services and medical transport to patients; (c) improve access to skilled diagnosis through tele-medicine; (d) improve the distribution of medical supplies; and (e) reduce the cost of medical supplies. In recognition of the fact that 80 per cent of the Kenyan population resides in the rural areas characterized by shortage of medical facilities and staff, telemedicine could be exploited to make it possible for various medical cadres to prescribe medicine and medicare to the general population cheaply. AMREF is exploring the possibility of combining its Flying Doctor Services with telemedicine, and expanding its network to reach patients in remote areas. In collaboration with the Ministry of Health, the foundation is targeting to use General Pocket Radio Service technology.

Other areas with potential for effective linkage with telecommunications, thereby creating jobs, include electronic preservation and documentation of cultural resources and research through the electronic media. In the area of food security and agriculture, ICT would facilitate development of information systems to improve on information access, markets, and trade to safeguard food security. Through ICT, farmers and agricultural industries can have access to urban and international markets. With support from the private sector, the Government plans to set up tele-info centres for this purpose. Further, information technology will be used to aid in environmental monitoring and assessment of natural resources (forests, wildlife, fisheries and forests). The use of GIS systems for monitoring climatic and other related changes gives one an opportunity to articulate intervention strategies in advance.

More generally, besides the huge potential demand that exists in the country for telecommunications services, there is even greater potential demand in the COMESA region, where most of the services are currently imported from developed countries. With significant progress being made in regional integration, Kenya needs to put in place the requisite basic infrastructure and other critical capacities in readiness for the COMESA market. One indicator of the potential in the country (and the region) is the fact that even with 5 million mobile telephone subscribers in Kenya at the moment, there is only 16 per cent penetration. In most of the other COMESA countries, penetration is much lower.

3.7 Conclusions and way forward

In this concluding section, the information presented in the preceding sections of the paper is synthesized in a systematic manner to suggest the way forward towards greater exploitation of the potential that exists in Kenya's telecommunications sector.

3.7.1 Main steps to ensure short-term and long-term efficiency, coverage and affordability of telecommunications services

The current state of telecommunications in Kenya, as presented in this paper, suggests that at least five main steps require to be taken in order to ensure short- and long-term efficiency, coverage and affordability of telecommunications services.

3.7.1.1 Network development and expansion

Although ICT infrastructure in certain instances looks satisfactory, especially in regional comparative terms, Kenya has a lot to do with regard to ICT infrastructure development and expansion to international standards in order to achieve the "digital divide" related Millennium Development Goals. There is need to attract new investment by incorporating adequate incentives in support of the liberalized telecommunications sector, including strengthening regional integration and therefore improving the business environment in the region. The Government is aware of this challenge and is taking various appropriate actions to address ICT based infrastructure deficiencies. The preliminary study report on the East African Regional Communication Strategy recommends that the infrastructure gaps that require urgent action in a regional context include:

- Establishment of high-capacity East African Backbone Links for improved connectivity regionally and internationally;
- Implementation of Lake Victoria links to improve communication and provide security and safety of travelers and seafarers;
- Harmonization and Licensing of Regional Links within the context of East African Customs Union to avoid the current exorbitant East African intraregional connectivity rates;
- Sharing of, and cooperation in, infrastructure facilities by competing operators in the same localities in order to cut costs.;
- Expansion of Fixed-line infrastructure to facilitate growth of e-enabled segments; and
- Long-term plans and strategies for bringing on board new telecommunications technology such as VSATs, DBS, GMPCS, GSO and third generation mobiles.

In the current National Development Plan, the Kenyan Government has listed many activities it intends to carry out over the next five to six years. These are projects that require substantial financial resources and provide opportunity for private sector investment and financial support from development partners. The activities include:

Expansion of switching capacity to over 950,000 lines	Project Expansion of the data services network (KENSTREAM)
Expansion of Internet Infrastructure (JAMBONET)	Installation of Electronic Data Interchange (EDI)
Expansion of data switching capacity (Kenpac)	Installation of intelligent network infrastructure
Regional Digital Transmission Project	Enhancement and expansion of internal security communication network
Africa One Project	Establishment of disaster communication network
COMESA Telecom Project (COMTEL)	Population management systems
Regional African Satellite Communication (RASCOM)	Government information and communications network

Besides these, energy infrastructure, especially in the rural areas is critical, requiring investment in alternative energy.

Development and expansion of national and regional infrastructure require the establishment of the universal service fund to facilitate extension of telecommunications services to the rural areas, and cooperation and coordination with regional and international organizations in the implementation of regional development programmes which impact or touch on telecommunications such as WSIS, United Nations development goals, ITU/BDT programmes, TICAD, NEPAD and ATU/PAPU.

3.7.1.2 Improvement in business environment

An enabling business environment is necessary to facilitate new investments and expansion of existing ones. The business environment is currently characterized by high cost of doing business due to (a) poor governance; (b) lack of basic infrastructure; (c) inadequate legal and regulatory frameworks; (d) inconsistency in policy frameworks; (e) bureaucratic red tape in license processing; (f) insecurity, which now costs the country over 40 per cent of investment; (g) and frequent policy reversals, which have impacted very negatively on the business environment. The World Bank's *World Development Report 2005* further indicates how unattractive the investment climate in Kenya is due to (a) policy and regulatory uncertainty and unpredictability; (b) corruption, which consumes 5.5 per cent of the sales of the average manufacturer; (c) the long procedures required to start a business; (d) sanctity of property rights and title; (e) crime levels; (f) inhibitive taxation; and (g) deficiencies in trade facilitating logistics, among others.

An enabling business environment calls for:

- Stable and predictable policy and regulatory environment through finalization of the national ICT policy;
- Adequate competition in the now-liberalized policy environment to create adequate capacity and ensure lower prices for consumers;
- Entrenchment of governance, rule of law and enforcement of security and codes of ethics;
- Identification of suitable incentives to encourage investment;
- Waiver of duty/tax on telecommunications equipment in line with WTO–Information Technogy Agreement (ITA) requirements, and removal of the 10 per cent airtime tax on mobile telephony services;
- Privatization of the incumbent fixed-line telecommunications operator;
- Harmonization of regional policies, regulations and tariff regimes to improve regional connectivity; and
- Promotion of the development of local content on the Internet to promote local e-activities and education.

3.7.1.3 ICT human resources development

Early training in ICTs should start through the introduction of basic ICT training in formal education programmes. In addition, ICT should be used as a tool to enhance the learning process. Senior management in both private and public sectors should be educated on the benefits of ICT. Tax incentives should be designed to encourage organizations to donate ICT facilities to educational institutions. In addition, universal access and service implementation should include schools to ensure telephone access and Internet.

3.7.1.4 Implementation of e-government services

Public sector interactions within itself (G2G) and between government and business (G2B) provide opportunities to kick-start the digitalization of the economy. Online delivery of public services will force both the business and public to acquire the skills for e-literacy.

3.7.1.5 Deliberate government investments and partnerships in the rural underserved sectors

Private sector investments in the rural area may not be profitable, given the levels of poverty and economic activity. In the initial stages, therefore, the Government may either invest directly in those areas or provide appropriate incentives for the private sector to do so.

3.7.2 Role of e-commerce

E-commerce holds the key to business success in the global environment. The sooner the Kenyan business community learns the enterprise, therefore, the sooner will valued added opportunities be realized. The role e-commerce can play in Kenya's development includes:

- Creation of investor confidence in the economy once it is digitally linked to the rest of the world;
- Diversification of economic activities and business actors in local, regional and global trade;
- Reduced regulatory requirements, which saves on time and other resources;
- Improvement in productivity, trade and quality of products due to enhanced access to markets and standards, increased flexibility in trading arrangements;
- Provision of equal opportunity of access for all regardless of status, size or other considerations; and
- Enhancement of trade in services, thereby enabling professionals and SMEs to export services without having to travel and face visa problems.

In order to reap the full benefits of e-commerce and ICT, however, there is an urgent need for the Kenyan Government to provide an enabling policy and legislative framework for e-commerce development, capacity-building in all sectors of the economy and adequate effort in promoting the use of e-commerce.

3.7.3 Role of trade and trade conditions

Trade opportunities are critically important in the further development, expansion and improvement of Kenya's telecommunications services through creation of a larger market and therefore an incentive for investors. Trade conditions are therefore also important because there are considerable barriers to trade, not only internationally but also regionally. For Kenya to fully exploit its potential in telecommunications, conditions for trade within COMESA need to be improved, as the regional market is critical for the country to build supply capacity and export competitiveness.

GATS offers a multilateral framework for countries such as Kenya to guarantee investors predictability and stability in policy, regulations and trade conditions. It allows such countries to specify conditions, such as joint ventures, that have the potential of yielding the desired outcomes. Such partnerships between foreign and local investors can yield substantial benefits, including:

- Observation and enforcement of international standards in the telecommunications sector;

- Technology transfer and relevant skills development to ensure productivity and competitiveness;
- Branding of the products and services; and
- Creation of market linkages for the traded products and services.

It is critical therefore for Kenya to participate effectively in multilateral, bilateral and regional trade negotiations. The country does not have adequate capacity to do this and should thus seek technical assistance to build capacity. Besides enhancement of trade negotiation capacity, such assistance could also build capacity on ICT sector-related issues, sourcing of appropriate technology, formulation of ICT-specific investment policies, and design of strategies supportive of technology transfer and business partnerships.

3.7.4 Steps to ensure gradualism and flexibility in liberalization

With the expiry of the exclusive period for Telkom in 2004, Kenya's telecommunications sector is fully liberalized at the policy level. However, the realities on the ground include a weak basic infrastructure base, weak human and other capacities, and inadequate understanding of the status and needs of the telecommunications sector, among others. Thus, there is need to gradually address these weaknesses before or as liberalization proceeds. In terms of sequencing liberalization for the purpose of maximizing benefits, it makes sense to liberalize basic telecommunications first because they are critical for the further development and expansion of telecommunications services and the economy in general, and because local capacity to roll out such infrastructure is lacking. Considering the centrality of this for further liberalization, development partners could be approached to facilitate laying of basic infrastructure, especially the minimum required for regional and global connectivity. It is necessary, moreover, to build capacity and skills in the regional context to enhance the domestic supply capacity and export competitiveness before liberalization is deepened. In this respect, technical assistance, technology transfer to bridge the technology gap, human resource development and continued involvement of government in the ICT investments are critically important.

Another key step to ensure gradualism and flexibility in liberalization is to take stock of the impact past episodes of liberalization have had, as a confidence building measure. Discussions with key public and private sector players indicate unambiguously that both sectors are scared of further liberalization of services within the multilateral framework because of ignorance about the likely impact. To ensure gradualism and flexibility in liberalization, therefore, it will be necessary to carry out impact studies and hold discussions and consultations with stakeholders. Related to this, there is also need to undertake further studies to identify sectors/areas for further work in the liberalized environment to facilitate making specific commitments under WTO with regard to most favoured nation (MFN) status, national treatment and universal service. However, recognition at the multilateral level of the liberalization that Kenya and other developing countries implemented under the World Bank/International Monetary Fund (IMF) and other autonomous programmes, and willingness to give credit for such liberalization, are important steps in the process as well.

3.7.5 Required regional, subregional and multilateral rules and commitments

At the multilateral level, as pointed out already, Kenya needs to commit a selected range of telecommunications services in which the country does not have adequate domestic capacity to provide, especially basic telecommunications that are also essential for other services to develop and expand. At this level, moreover, it might be important to reconsider the rules associated with revising a country's schedule of commitments. The difficulty of doing this currently makes the cost of making a mistake in the commitments too high, thereby making many countries reluctant to make commitments. Taking this into consideration and the fact that most developing countries made the initial commitments without adequate consideration of impact or stakeholder consultations, it might be useful to offer such countries an opportunity to make revisions of their schedules as a confidence-building undertaking.

Additionally, multilateral rules need to be well balanced to ensure that universal service can be attained at competitively priced costs, and that the Government's revenue bases and policy flexibilities supportive of development are not unduly eroded.

Kenya belongs to several regional and sub-regional integration arrangements, key among them EAC, which became a customs union with effect from 1 January 2005, and COMESA. In addition, the country is partner in ESA countries currently negotiating an economic partnership agreement with the European Union. Trade in services has not been negotiated yet in any of these arrangements. Yet, it is at the regional and sub-regional levels where clear and predictable trade rules and preferential access arrangements are critically important to build supply capacity and export competitiveness.

Within EAC, however, a number of positive actions have been carried out with a view to harmonizing services. Rules and commitments that are productive to Kenya from the East African perspective include:

- Liberalized telecommunications sector. Whereas Kenya has liberalized its telecommunications sector, the other partner States have yet to take this resolution. It is necessary that the other partner States liberalize their telecommunications sectors for a harmonized policy development, sharing of infrastructure investment, institutionalized interconnectivity and legal and regulatory reforms. The players in the market of the three East African countries can quickly make arrangements to provide services in partnerships that would facilitate roaming facilities initially but that are eventually converted into single service providers when mergers take place. A case in point is Celtel, which is presently in the three East African counties and has to operate on international basis across the borders of the three partner States.
- Liberalized regional market access for the enhancement of supply capacity and export competitiveness. This would allow for the e-enabled segments of the three economies to develop in harmony while taking advantage of scale economies. Furthermore, the business community can transact large orders while producing from different sites within East Africa.
- Harmonization of tariff regimes to facilitate bigger investments by both local and foreign investors.
- Setting up of call centres as a priority to create employment opportunities.

Some of the counterproductive measures that occur in East Africa relate to prolonged negotiations on the harmonization of the telecommunications sectors, and membership to multiple and overlapping integration schemes that is also delaying harmonization of telecommunications policies. While Kenya and Uganda belong to COMESA, the United Republic of Tanzania is a member of the Southern Africa Development Community (SADC). COMESA and SADC have different timeframes on the development of the telecommunications sector. There is need not only for the three EAC member States to rationalize their commitments to various integration schemes, but also for the African Union to chart out a continental telecommunications development programme.

3.7.6 Role of public policies

Whereas Kenya's ICT policy has not been fully developed, the Government has taken deliberate and conscious effort to promote ICT development in the country in partnership with the private sector and academia. The multi-functionality of ICT in everyday life calls for innovative public policies to support and promote ICT services. These include:

(a) Investor-friendly fiscal and related policies, including removal of the 10 per cent airtime tax and implementation of the WTO–ITA requirements of duty-free ICT products and services, which are currently attracting 25 per cent duty. It should be noted, however, that taxation of computers and telecommunications equipment has been reduced substantially to improve accessibility and affordability. Due to liberalization, technology development and reduction/elimination of taxation, for example, computers which cost $3,000 five years ago now go for $300, while mobile phone handsets that cost $5,000 go for as little as $50. There is room for the cost of mobile phone handsets and other telecommunications products and services to reduce further if the 25 per cent duty is removed. The 10 per cent airtime tax also makes local calls too expensive, taking into account that mobiles now constitute the main form of voice communication in both urban and rural areas.

(b) Human resource development policy including incorporation of ICT in regular training curriculum from primary to university education, promotion of e-government service delivery, modernization of government management services, and implantation of back-office operations through off shoring and outsourcing.

(c) Planning of and investment in infrastructure to support a growing ICT industry and improve connectivity.

(d) Legal and regulatory frameworks that support e-enabled businesses and service delivery and safeguard the interests of investors and users.

(e) Further liberalization in a judicious, consultative and gradual manner. Liberalization of the telecommunications services, particularly those that are Internet-based, has set the stage for massive growth in the ICT sector. Already, VoIP service provision has experienced tremendous growth since being liberalized. Prices have fallen to about Kshs 8 ($.10 per minute), which is comparable to international pricing. It is therefore important for the Government to take trade negotiations seriously and to build adequate capacity for it.

(f) Encouragement and implementation of e-government services, as these will improve governance by reducing corruption and improving efficiency of service delivery. The Government approved the e-government strategy in December 2003 and has already established a Directorate for e-Government.

Chapter four

Financial services: banking

4.0 Introduction

Like telecommunications, financial services play an infrastructure role in driving trade and service, and are a key element of an enabling investment climate. The services underpin global economic growth and provide infrastructure for trade in goods and services. They are key drivers of development process, linking investors and lenders. Not only does the financial sector ensure intermediation between people with surplus income and investors, it also facilitates exchanges in the goods and services market. Moreover, it provides an opportunity for households and enterprises to better manage risks. A good financial system ensures efficient mobilization of domestic savings, attractive returns to investors and savers, encourages sound institutional management and competitive charges for financial services, and attracts foreign funds. On the other hand, inadequacies in finance impede exploitation of opportunities, increase costs for enterprises and limit competition, and therefore innovation and productivity (World Bank, 2005).

Why are inadequacies in financial services prevalent, especially in developing countries? The underlying problem is basically market failure arising from information asymmetry (World Bank, 2005). In simple terms, what this means is that lenders have imperfect information on the risk of default in repayment and cannot therefore adequately protect themselves. When they raise interest rates for this purpose, it discourages honest investors and those with low risk and low return investments. The asymmetry, additionally, makes it difficult for firms to borrow without collateral, which has a disproportional adverse impact on credit access by small firms and the poor. The severity of the asymmetry problem depends upon the level of technology and thus its effect on the cost of accessing better information, and government policy or political economy in general.

In an attempt to address this market failure, government intervention worsens the situation. Thus, State ownership, monopolies, directed or subsidized credit, and other policies motivated by short-term political interests have repressed and distorted financial markets (World Bank, 2005). This underscores the importance of well-balanced and judicious financial sector policies.

This chapter discusses how short- and long-term efficiency, coverage and affordability of banking services in Kenya could be ensured through e-banking, trade and trade-related conditions, gradual and flexible liberalization, regional, subregional and multilateral rules and commitments. It analyses the main features of the sector, the main players and their characteristics, the legal and policy framework, the regulatory institutions and the main challenges they face, the performance trends over time and of domestically owned banks relative to foreign ones, and the implications of liberalization of banking services on sector stability and capital movements.

4.1 Kenya's banking sector: an overview

Kenya's banking sector has grown tremendously over the years, from only 9 commercial banks at the time of independence in 1963, to 53 by the beginning of 2000, although this has now declined to about 43 largely due to mergers. In addition, there are 7 non-bank financial institutions (NBFIs), 4 building societies, 2 mortgage finance companies, 48 independent foreign exchange bureaux, and a number of other related banking institutions. The sector is highly concentrated, with the 10 largest commercial banks accounting for 72 per cent of all deposits in 2001 and 77.3 per cent in 2002 (Kenya, 2003). By 2004, the top 13 commercial banks controlled about 80 per cent of the deposits and about 73 per cent of the total assets. Total commercial bank deposits and assets in 2004 stood at, respectively, Kshs 465.6 billion and 577.6 billion (table 4.1).

Table 4.1. Balance sheet for all commercial banks in Kenya, 2003–2004, Kshs millions

Assets	**2004**	**2003**	**% Change**
Cash	10,298	9,688	6
Balance at Central Bank of Kenya	32,767	24,408	34
Placements	13,582	12,330	10
Government securities	115,994	143,049	(19)
Investments	5,056	4,555	11
Loans and advances (net)	301,891	240,701	25
Other assets	98,061	81,068	21
Total assets	**577,649**	**515,799**	**12**
Liabilities and shareholders funds			
Deposits	465,572	415,972	12
Other liabilities	43,245	38,834	11
Capital and reserves	68,829	60,993	13
Total liabilities and shareholders' funds	**577,649**	**515,799**	**12**

Source: Central Bank of Kenya, Bank Supervision Report 2005.

Prior to independence in 1963, Kenya's and other East African banks operated under the guidance of the East African Currency Board, under the direction of the Bank of England. The currency used then was the Great Britain Pound (GBP). There was little reporting and capture of banking data at the domestic level until 1966, when the Central Bank of Kenya (CBK) was established by an act of Parliament (Cap 491), as an umbrella regulatory board of the monetary sector.

In the 1970s and 1980s, the banking sector in Kenya was characterized by two major external events. First was the oil crisis of 1974, when the prices of crude oil doubled due to the Israeli–Arab war. This affected purchasing power through increased prices and general inflation, which also made loans expensive with serious economic impact. Second, the coffee boom experienced in the country in the late 1970s and early 1980s enabled many Kenyans to open banks. Due to weak regulatory systems, however, the increased liquidity from international coffee sales led to relaxation of prudence, mismanagement and collapse of some of the banks. With depositors losing their money, this led to considerable loss of confidence in the domestically-owned banks.

In response to these failures, CBK strengthened bank supervision in the late 1980s. More reforms were introduced in the 1990s under the World Bank's structural adjustment programme, aimed at strengthening the regulatory framework to protect depositors and reduce incidences of insider borrowing. As a result of these reforms, the banking sector has gradually moved away from foreign domination, at the time of independence in 1963, to one having significant domestic ownership and participation by Kenyans despite several episodes of failure for domestically owned banks.

4.2 Policy, legal framework and structure of banking

The policy, legal and regulatory, and thus the structural aspects of banking in Kenya have undergone considerable change since independence, as is evident from the short account presented in the preceding section. Such change is important because, besides the effect of technology, the political economy in general and government policy in particular are the main determinants of the severity of the information asymmetry problem that is at the core of problems in the banking sector (World Bank, 2005). The World Bank (2005 and 2006) has identified the key policy constraints or issues for banking around the world:

- Significant State ownership of banks affects their performance by reducing overall access to finance, reducing private competition and thus impeding development of the financial system, worsening allocation of credit and increasing the likelihood of financial crises.
- Development financial institutions can play the crucial role of subsidizing credit to segments of society unable to access banks if their governance arrangements are strong. But they tend to fail because of poor decision-making that leads to low repayment rates.
- Directed credit usually leads to problems such as use of credit for unintended purposes, corruption, failure to reach the target beneficiaries and slowing of the development of financial markets.
- Credit guarantees can encourage lending to the riskier borrowers such as new and small firms, but are often affected by lack of incentive for banks to vigilantly assess risk and monitor borrowers, thereby leading to high default rates and failure to reach the target beneficiaries.
- Macroeconomic stability (through low inflation, sustainable debt, realistic exchange rates and low fiscal deficits) is important to ensure stable interest rates, exchange rates and relative prices, and to ensure that credit to the private sector is not crowded out.
- Competition has been found to improve banking stability, reduce interest rate margins and expand access to finance, thereby spurring economic and employment growth. Competition can be fostered through issuance of new domestic banking licenses, including to foreign banks, stimulating other forms of finance (such as public bond financing, NBFIs, pension and contractual savings and commercial microfinance), technological innovation and information sharing.
- Rapid liberalization and privatization, before adequate regulatory capacity is established, could lead to highly concentrated benefits and therefore reform backlash. This happened in Chile in the 1970s, Mexico in the 1980s and the Russian Federation in the 1990s.
- Clearly defined, secure and enforceable rights of borrowers, creditors and shareholders, and laws and registries allowing collateralization of movable property are critical for the development of financial markets.
- Good corporate governance achievable through greater transparency, use of international accounting standards, appointment of independent directors, and stricter disclosure requirements and enforcement by Government, are also very important, especially for foreign investors.
- Use of credit information bureaus increases bank lending, reduces default rates, and improves lending to new and small firms through reduced transactions cost of obtaining information about them. There is need, however, for regular monitoring of the credibility and independence of rating agencies.

- Regulations that require information disclosure by banks could be superior to such other risk-taking control measures as deposit insurance and prudential regulation and supervision. The problem with deposit insurance is that it can make people less careful in assessing the soundness of banks while prudential regulation and supervision may be affected by lack of adequate financial resources and technical capacity, corruption and clientelism where banks “capture” their supervisors.

These provide a framework upon which Kenya’s banking policies and legislation could be assessed.

4.2.1 Development of banking in Kenya: historical overview and main features
Kenya achieved independence from the United Kingdom in December 1963. As a British colony, most of the banks were British or Indian in origin and served the interests of the colonialists, who were mainly settler farmers. There were also Indian “coolies” and traders brought by the British to assist in the construction of the Kenya–Uganda Railway. The earliest banks recorded to have started operations in Kenya were Standard Bank of South Africa in 1910 and the National Bank of South Africa in 1916. The latter merged with Colonial bank and Anglo-Egyptian bank to form Barclays Bank. Other banks that came into the scene were ABN-AMRO from the Netherlands in 1951, Habib bank from Pakistan in 1956, Ottoman bank from Turkey in 1958 and Commercial bank of Africa in 1962. The equity market and the Nairobi Stock Exchange (NSE) were developed in the 1920s. All these were foreign owned or controlled and were established to serve the interests of the minority white and Asian communities, which at that time were mainly foreign traders of their agricultural produce from Kenya.

After independence, the banking landscape changed. The Government promoted a policy of Africanization or indigenization. Local Kenyans took over civil service jobs left by the departing British and Indians. They also set in motion processes of purchasing farms from the departing settlers. Consequently, they needed their banks to assist in this process. This led to the formation of Cooperative Bank of Kenya in 1965 and National Bank of Kenya (NBK) in 1968. In 1971, the Government acquired 40 per cent interest in Grindlay’s Bank, which was later renamed Kenya Commercial bank (KCB). In the early 1970s, the Government introduced a policy to encourage development of NBFIs, with the objective of increasing local participation in the financial sector and increasing the supply of long-term capital. The policy included lower capital base relative to commercial banks, and permission to charge higher interest rates on loans and offer higher interest rates on savings, whereas the commercial banks operated within controlled interest rates. This had the effect of shifting considerable deposits from the banks to the NBFIs. By 1987, consequently, the country had a total of 54 NBFIs in operation. In the late 1970s, many local banks were formed using proceeds from the “coffee boom”.

This growth in NBFIs and banks was, however, not supported with adequate supervision from CBK. The Central Bank lacked adequate capacity for supervision and surveillance, which eventually led to some bank failures.

Currently, the Kenyan banking sector is diverse but some areas are still underdeveloped. It is still dominated by a few large banks, most of which are owned by foreign investors. As a result of this and other weaknesses, the sector is characterized by high interest rate spreads due to high lending rates and very low deposit rates. The big banks have high profitability while most of the others have high non-performing loans (NPLs) and inappropriate or inadequate risk management (see tables

4.3 and 4.4). The formal banking sector is estimated to serve only 10 per cent of the population. Consequently, microfinance institutions and informal financial institutions are playing an important role in providing financial services to the marginalized segments of the Kenyan society.

4.2.2 Structure, main players and their characteristics

Like those of other countries, the Kenyan financial sector consists of depository, contract and conduit financial intermediaries. Depository financial intermediaries in the country include (a) commercial banks; (b) savings banks, such as Postbank; (c) savings and loans; (d) finance companies; and (e) savings and credit societies (SACCOs). Contract intermediaries include life assurance companies, insurance companies and pension funds, while conduit intermediaries in the country include building societies, investment companies and real estate investment agencies. Other financial institutions that facilitate intermediation of assets and securities between buyers and sellers include the Nairobi Stock Exchange (NSE), trusts and mortgage companies.

The Kenyan banking sector currently consists of 43 commercial banks, 4 building societies, 2 mortgage finance companies, 1 NBFI, and 89 foreign exchange bureaus (table 4.2). In addition, there are 1,352 retirement benefits schemes with the largest among them being the mandatory National Social Security Fund (NSSF), and over 6,000 SACCOs.

Table 4.2. Current structure of the Kenyan banking sector

Type of institution/bureau	April 2004	April 2005
Commercial banks	**43**	**43**
(a) Operating	42	42
(b) Under Central Bank statutory management	1	1
Building Societies	**4**	**4**
(a) Operating	3	2
(b) Under Central Bank statutory management	1	1
Mortgage finance companies	**2**	**2**
NBFIs	**2**	**1**
Winding up NBFIs	0	1
Total	51	49
Foreign exchange bureaus	**48**	**89**
(a) Operating	48	89
(b) Licensed but not operating	0	0
(c) Those whose application was being processed	0	8

Source: Central Bank of Kenya.

In general, the development of banking in Kenya has been characterized by rapid expansion until the 1980s and 1990s, and major weaknesses and challenges thereafter. Thus, the number of banks rose from 20 in 1984 to 56 in 1998 before falling to the current number of 43. On the other hand, NBFIs increased from 32 in 1984 to 54 only three years later before decreasing to only 2 currently. The number of mortgage houses has remained 2 since 1996 but that of building societies fell from 17 in 1989 to only 4 currently. The number of foreign exchange bureaus, however, increased from 31 in 1996 to 89 currently.

4.2.2.1 Commercial banks

Banks receive deposits from the public and lend to investors through more than 600 branches and automated teller machines (ATMs) which are spread all over the country. As the banks receive deposits from the public, they reward them with interest. They also lend and charge interest on borrowers. Lending is carried out in accordance with prudential guidelines issued by CBK in line with the Basel Accord which stipulates requirements such as capital adequacy, supervision by CBK and other statutory authorities, and market disclosures (informing the general public and investors on banks performance through quarterly financial statements and other disclosures). More generally, the financial services that commercial banks offer include current accounts, deposit and savings accounts, card services and cash machines, loans and overdrafts, payment systems including standing orders, foreign exchange transactions, and electronic purse. Of the 43 banks in the country, 7 are foreign owned and 6 are foreign owned but locally incorporated.

4.2.2.2 Foreign exchange bureaus

Foreign exchange bureaus are licensed to receive and disburse foreign currencies at market rates. The introduction of these bureaus has created confidence and increased competition in the foreign exchange sector. By December 2004, the country had 89 foreign exchange bureaus, up from 80 a year earlier and from 31 in 1996. About 79 per cent of these are located in Nairobi alone and another 13 per cent in Mombasa.

4.2.2.3 Nairobi Stock Exchange

NSE intermediates equity securities between the 41 companies listed currently and members of the public and investors who purchase shares. The exchange is a leading secondary market for trading securities. The listed companies fall into various economic segments including agriculture, commercial and services, finance and investments, and Industrial and allied, among others.

The Capital Markets Authority (CMA) is the institution charged with responsibility to license players in the securities intermediation market. The players include stockbrokers and dealers, investment advisors, fund managers, authorized depositories and investment banks.

4.2.2.4 Asset/fund managers

Asset or fund managers are responsible for managing collective investments such as pension and provident funds. There are regulations on investments made by fund managers touching on issues such as consistency with the objectives of the scheme, transferability, adequate proof of ownership and the nature of investment portfolio. Thus, for instance, the share of offshore investment in the portfolio should not exceed 10 per cent.

4.2.2.5 Special financial institutions

Special or development financial institutions were set up after Kenya's independence in 1963 to facilitate special intermediation, that is to help indigenous Kenyans get into business and commercial agriculture. They were used to speed up the process of Africanization. These institutions include:

Industrial and Commercial Development Corporation: ICDC was set up in 1964 to acquire equity and extend loans to small, medium and large industrial and commercial projects. It serves the locals who need loans for working capital in their businesses or start up capital.

Development Finance Company of Kenya: DFCK was established in 1964 to acquire equity and extend loans to small, medium and large-scale enterprises.

Kenya Tourist Development Corporation: KTDC was established in 1965 to acquire equity in and extend loans to tourism projects and facilitate hotel management.

Kenya Industrial Estate: KIE was set up in 1967 to facilitate the development of industrial estates. It provides small and medium enterprises loans to buy machinery and other industrial equipment.

Agricultural Development Corporation: ADC was established in 1965 to facilitate management of State and private farms, and acquire equity in and extend loans to agro-industrial enterprises. This served the Kenyans who needed to borrow in order to purchase large-scale farms that were left by the departing white settlers soon after independence.

Agricultural Finance Corporation: AFC was established in 1969 to provide agricultural loans. It offers seasonal loans to large-scale farmers and loans for farmland purchases.

Industrial Development Bank: IDB was established in 1973 to acquire equity and extend loans to medium and large industrial projects. The bulk of the SMEs borrow money for working capital and machinery from this bank.

Kenya Post Office Savings Bank: KPOSB was established by the Government as a formal savings mechanism to mobilize savings from small savers using the extensive post office network in the country, which consists of over 900 Post offices.

4.2.2.6 Microfinance Institutions

Kenya's microfinance industry is the oldest in Africa and is a leader in micro lending technologies. Its development started in the 1960s and 1970s in the form of targeted agricultural credit from the government and international donor agencies (KIPPRA, 2005b). MFIs are now the main providers of financial services to the micro-enterprises and SMEs and, in general, the low-income population. They are creating employment and empowering the most vulnerable segments of the Kenyan society, which includes women, youth, rural and urban poor. They are helping small businesses and poor people deal with school fees, emergencies, and life-threatening problems. Unlike the large commercial banks, MFIs have managed to record reasonably low default rates due to trust and group lending. Microfinance is based on the principle of people who share a common bond coming together and guaranteeing one another loans.

The microfinance system consists of grassroots savings and credit cooperatives, microfinance NGOs, commercial banks, finance companies, cooperative banks, regulated MFIs, insurance companies and wholesale financing institutions (KIPPRA, 2005b). K-Rep is one of the most famous MFIs, having transformed itself from an NGO into a full-fledged bank, complete with foreign investor presence. It was the first in the continent to make such a transformation. Equity Building Society also recently converted into a commercial bank; Equity Bank Ltd. has been honoured by the United Nations for its role in poverty reduction, facilitating access of the rural people to loans.[40]

There are over 6,000 registered SACCOs in the country, estimated to be worth over Kshs 100 billion, substituting commercial banks in the provision of financial services to Kenyans across all income categories. SACCOs are member institutions, with members being those with a common bond with the objective of saving and guaranteeing each other credit from the SACCOs.

While the MFI sector plays a crucial role, it operates without regulations and is therefore not allowed to take deposits from the public, despite the existence of huge demand for business in that

[40] *The Sunday Nation*, Business Sunday, 13 March 2005:17.

direction. To facilitate fuller exploitation of their potential, stakeholders have been pushing for the development of a legal and regulatory framework for MFIs. Consequently, an MFI bill has been drafted, although it is yet to be enacted into law by Parliament. Among others, this MFIs legislation:

- Defines qualifications for carrying out deposit taking microfinance business;
- Provides a procedure and requirements to apply for licensing to carry out deposit-taking microfinance business;
- Specifies minimum liquid assets an institution shall maintain to be allowed to carry out a deposit-taking microfinance;
- Determines prohibited activities for the licensed microfinance institutions;
- Provides for ownership and corporate governance, including a “fit and proper” test for the owners and directors of microfinance institutions.
- Provides for deposit protection for customers of microfinance institutions; and
- Specifies limits on loans and advances in aggregate to core capital.

4.2.3 Legal, regulatory and policy frameworks
Financial (banking) services in Kenya are regulated by two statutes of Parliament and Kenya Bankers Association (KBA) – the Banking Act (Cap. 488) and the Central Bank Act (Cap. 491).

4.2.3.1 The Banking Act (Cap. 488)
The Banking Act regulates commercial banking and specifies (a) licensing procedures; (b) prohibited businesses and other restrictions; (c) rules on reserves and dividends; (d) financial reporting and audit requirements; (e) inspection and control provisions for licensed institutions; (f) establishment of the Deposit Protection Fund (DPF); (g) export of banking services by representation of foreign banking institutions, that is, commercial presence; (h) restrictions on increase in banking charges; (i) penalties for offences; (j) provisions against misleading advertisements for deposits; and (k) exceptions for the specialized institutions such as the Agricultural Finance Corporation (AFC), Kenya Post Office Savings Bank (KPOSB), Industrial and Commercial Development Corporation (ICDC), and Kenya Industrial Estates (KIE), among others.

In order to ensure efficiency, viability, sustainability and harmonization of the Banking Act with the Basel Accord and corporate governance, the following amendments have been recently made:

- Repeal of section 39 of the Central Bank of Kenya Act, which regulates interest rates charged to borrowers;
- Repeal of section 44 of the Banking Act, which requires financial institutions to obtain approval from the Minister of Finance before increasing banking rates and other charges;
- Introduction of a new section 44 (a) on the *in-duplum* rule, which limits the total interest an institution can recover on a non-performing loan to a maximum of the amount of outstanding at the time it became non-performing; and
- Introduction of vetting of significant shareholders who are from the Government or a public entity, who hold directly or indirectly, or otherwise have beneficial interest in, more than 5 per cent of the share capital of an institution.

4.2.3.2 The Central Bank Act (Cap. 491)
The Central Bank Act establishes the CBK and specifies its functions, which include to:

- Formulate and implement monetary policy that maintains stability and general price levels;

- Foster liquidity, solvency and ensure proper functioning and stable market based financial system;
- Formulate and implement foreign exchange policy;
- Hold and manage foreign exchange reserves;
- License and supervise authorized dealers in the money market;
- Promote the smooth operations of payments, clearing and settlement system;
- Act as banker, advisor to and as fiscal agent of the Government of Kenya; and
- Issue currency notes and coins.

4.2.3.3 Other statutes

Other statutes that interface with operation of banks in Kenya include (a) Capital Markets Authority (CMA) Act (Cap 495A), which establishes the CMA as the regulator of the equities market; (b) Companies Act (Cap 486), which regulates company incorporation processes, operations and dissolution; (c) Land Acts (Caps 300,280,281) that address all matters relating to land ownership, bank security, legal charges and discharges; (d) Law of Contract (Cap 23) that deals with trade contracts, customer bank legal relations, duties and obligations, among others; (e) Bills of Exchange Act (Cap 27); (f) Cheques Act (Cap 35); and (g) Insurance Act (Cap 487).

4.2.3.4 Adequacy of regulatory framework

The regulatory framework is somewhat unclear, especially with respect to granting of authority for private sector firms wishing to list bonds. For example, an application by Barclays Bank to list a bond to finance a mortgage facility has not been acted upon either by the CBK or CMA yet. Other regulatory constraints in the Kenyan financial sector include the fact that the microfinance bill has not been enacted yet, lack of consensus on the regulatory framework required for SACCOs that are offering front office banking services, and the fact that the Post Office Bank of Kenya Act prohibits it from extending credit yet it receives considerable deposits from small savers. The Privatization Bill and the Central Depository System (CDS) Act also need to be speedily enacted to guide the Government in further divestiture, improve investor confidence, and improve the liquidity of the stock market and overall regulatory framework.

4.2.3.5 Policy reforms

Before implementation of the World Bank/IMF-sponsored reforms of structural adjustment programmes began in 1980, several problems characterized the banking sector (Ikiara et al., 2003):

- Under-capitalization due to low entry requirements for NBFI;
- High State ownership;
- Ceilings on deposits and control of interest rates;
- Quantitative restrictions and government directives on credit allocation; and
- Political patronage and economic abuse, which weakened the development of the financial system and failed to address the problem of long-term credit and financial mismatch between short-term liabilities and long-term assets.

As discussed in the introduction to this section, these are some of the factors that form the core of financial market problems around the world. Not surprisingly, therefore, the country's banking sector performed poorly during this period, as will be evident in a later section.

Within the SAPs package, and afterwards, the country implemented a number of financial sector reforms aimed at tightening the regulatory environment, fostering competition, and enhancing efficiency in the sector (Ikiara et al., 2003; KIPPRA, 2005b).

4.2.3.6 Foreign participation

Policy reforms in this sector have remained relatively liberal over the years, with only limited restrictions on the entry of both foreign and domestic investors. In 1986, for instance, a restriction was introduced requiring foreign-owned banks to have twice the minimum paid-up capital required of locally-owned banks. This differential was, however, gradually reduced, and was completely eliminated by 1999. In the case of stock brokerage, foreign ownership was restricted to a maximum of 51 per cent of the total shareholding, although this has been gradually relaxed to 75 per cent. In the area of asset or fund management, moreover, the share of offshore investment in the portfolio is not allowed to be in excess of 10 per cent. One of the unrestricted financial services is cross-border trade in financial securities. Foreigners can freely provide advisory services to domestic firms and residents in areas such as mergers and acquisitions, investment and credit rating. Foreign investors in the stock market are subject to 7.5 per cent withholding tax on dividends compared with 5 per cent for local investors.

4.2.3.7 Capital Markets Authority

The CMA was established in 1990 to facilitate development of a more vibrant capital market. In 1995, the CMA partnered with the NSE to establish a fund for investment protection. In addition, stock market operations have been reorganized, including recent implementation of the CDS and introduction of an automated trading system.

4.2.3.8 Liberalization of interest rates regime

Interest rates were deregulated in 1991, leading to a sharp increase in virtually all the principal interest rates in the country. Maximum commercial bank loans and advance rates, for example, more than doubled, from 14 per cent in 1985 to over 30 per cent by 1997. The increase was attributable to the oligopolistic structure of the banking sector (in which the market is dominated by four major banks), the stringent cash and liquidity ratios imposed on banks that reduced the amount of money available for intermediation, and high government borrowing from the banking sector through weekly Treasury Bills instruments.

4.2.3.9 Establishment of the Deposit Protection Fund

The Central Bank established the DPF to protect depositors, especially small ones. Banks and NBFIs contribute 0.1 per cent of their deposit liability every year to the fund. Acting like an insurance scheme, the fund pays a maximum of Kshs 100,000 to a depositor in the event of a collapsed bank. It also oversees receiverships, liquidation and winding up of collapsed banks and NBFIs, and uses the proceeds to settle the bank's/NBFI's debts and protected depositors.

4.2.3.10 Strengthening of regulatory authority

Over time, the Central Bank's regulatory authority and its capacity for supervision have been strengthened through amendments to the CBK Act. The Central Bank now has a Financial Institutions Supervision Department and compliance with regulations in the sector has improved considerably, as will become evident in the section on performance.

4.2.3.11 Changes in minimum capital
In 2003 and 2004, entry barriers to the financial sector were lowered. Minimum paid up capital for banks was reduced from Kshs 500 million to 250 million, while that for NBFIs was reduced from 375 million to 200 million. This enabled some NBFIs such as K-Rep and Equity Bank to convert to banks. At the same time, the cash ratio requirement was reduced from 10 per cent to 6 per cent.

4.2.3.12 Privatization
One of the key policy reforms that have changed the face of the Kenyan banking sector is divestiture of Government. Since the 1990s, most of the government shares in banking institutions – such as Kenya Commercial Bank, National Bank of Kenya, and Housing Finance Company of Kenya – have been sold to the private sector, with the NSE playing a major role in this.

4.2.3.13 Performance disclosure requirements
Greater and more frequent (quarterly) bank performance disclosure requirements were introduced by the Central Bank in 2002 and require banks and NBFIs to publish and distribute publicly their unaudited financial results every quarter. This enables bank customers, investors and the general public to make informed investment decisions.

4.2.3.14 Financial Sector Deepening programme
FSD is a five-year State/donor supported programme that started in early 2005 with an ambitious objective of extending sustainable financial services, especially savings, to the poorest segments of the country – that is, those that are not reached by even the microfinance institutions. The specific core objectives of the FSD programme are:

- Developing financial services delivery channels by developing appropriate products and building the capacity of financial institutions to access this market;
- Setting up structures and capacities for services to be offered in rural and remote areas;
- Spreading services to the agricultural sector; and
- Developing systems that allow institutions to deal with SMEs and still make profits.

The programme, moreover, proposes a study to establish why many Kenyans do not use banks.

4.2.3.15 Other reforms
Other reforms in the country's financial sector have included (a) minimization of government directives on credit allocation; (b) removal of foreign exchange controls in 1993; (c) minimization of taxation of financial instruments; (d) management of bank insolvencies; and (e) restructuring of the development finance institutions.

Some of the most recent financial sector reforms, moreover, are those announced by the Minister for Finance during the June 2004 and 2005 budget speeches. These included:

- Control of bank charges through section 44 of the CBK Act;
- Introduction of *in-duplum* rule to ensure that the maximum interest chargeable on a loan does not exceed the principal loan outstanding;
- Introduction of the Cheque Truncation System to facilitate electronic rather than physical movement of cheques between banks;
- Restructuring of banks with government ownership to prepare them for privatization. These include the KCB, NBK, Cooperative Bank, Consolidated Bank and the Industrial Development Bank (IDB);

- Promotion and enhancement of corporate governance and anti-money laundering; and
- Development of a microfinance bill.

It should be noted, however, that these interventions have not started being implemented due to delay in the enactment of the Banking Amendment Bill 2004 that sought to legally entrench them. Besides these, the Government is also working with international bodies such as the IMF and World Bank to overhaul the financial sector, principally by boosting regulation and efficiency of commercial banks and MFIs, and by facilitating privatization of State banks.

In the current economic blueprint, the Economic Recovery Strategy (ERS), the Government plans to (a) implement monetary policy reforms that would further enhance the independence and performance of the monetary authority; (b) implement fiscal reforms in favour of domestic debt financing through longer-term securities such as bonds rather than shorter term treasury bills; and (c) introduce a bank rate as a signaling tool in the management of interest rates in the country.

4.2.4 Regulatory institutions and the main challenges

With the exception of SACCOs, all other players in the Kenyan financial sector are regulated under the Ministry of Finance. SACCOs are regulated under the ministry in charge of cooperatives. Within the Ministry of Finance there are several regulatory agencies: CBK, CMA, and the Retirement Benefits Authority (RBA). The CBK regulates all banks, NBFIs, building societies, deposit-taking institutions and money markets. In addition, there are proposals to place microfinance institutions under the regulatory authority of the CBK. The CMA regulates securities and investment related institutions while the RBA regulates retirement benefits industry.

4.2.4.1 Central Bank of Kenya

CBK has long been a key player in the country's financial sector. Its regulatory capacity has been considerably increased over the years through amendments to the Central Bank Act. In 1985, amendments introduced prudential regulations: capital requirements, capital quality, liquidity levels, minimum qualifications for management and other key personnel, prudent lending policies, internal controls, new powers to Central Bank to enforce solvency, mandatory deposit insurance, and authority to appoint financial advisors for poorly performing banks. In the 1990s, furthermore, the CBK was accorded autonomy to license and supervise banks and NBFIs, and formulate banking policies. As a result, the Bank Supervision Department was created at the Central Bank to enforce the liquidity, solvency, efficiency and other prudential measures of the Banking Act.

In its progressive improvement of regulatory and supervisory capacity, the CBK is now implementing risk-based supervision, which focuses on risk mitigation as opposed to avoidance. It has introduced tough guidelines for managing nine of the most critical risks[41] that banks face and ordered banks that do not have independent risk management structures (reporting directly to the Board of Directors) to set them up. The bank is also working to strengthen corporate governance practices at the board and shareholder levels of commercial banks. The Central Bank recommends to the Minister for Finance the banks whose corporate approvals can be granted or withdrawn. In line with international best practices, however, this power is gradually being shifted from the Minister to the Central Bank. The CBK has also recently introduced guidelines on how to calculate income from interest, with interest on non-performing loans excluded from such income.

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[41] The nine risks are those that relate to strategy, credit, liquidity, interest rates, foreign exchange, price, operations, reputation and compliance with regulations.

The other measures CBK is taking in an effort to upgrade bank supervision in the country to international standards include (a) capacity-building for the relevant staff at the Bank's Kenya School of Monetary Studies and through a pilot subscription scheme to the Financial Stability Institute for Skills Development on the Basel framework; (b) participation in regional initiatives on harmonization of banking supervision within the framework of Monetary Affairs Committee; (c) use of ICT solutions (Bank Supervision Application, BSA) for automated banking supervision among the Eastern and Southern Africa Central Banks; and (d) working with other stakeholders towards the introduction of an anti-money laundering legislation.

There are weaknesses in the bank supervision, however, that may undermine the stability of the country's banking sector. These include the resolution of NPLs that constituted about 21 per cent of total loans in 2004. These NPLs were concentrated in five banks with some government interest, that is, National Bank of Kenya, Kenya Commercial Bank, Consolidated Bank, Industrial Development Bank and Cooperative Bank.

4.2.4.2 Capital Markets Authority

The CMA was established in 1990 under the Capital Markets Authority (CMA) Act, with the following mandate: development and regulation of the capital markets by facilitating self-regulation, and protection of foreign and other investors. CMA carries out intensive industry surveillance to safeguard integrity and therefore investor confidence. To improve and strengthen the capital market, CMA plans to double the minimum capital requirements for stockbrokers to Kshs 10 million, and is encouraging stockbrokers to convert into investment banks. Prior to CMA establishment, the industry was overseen by the Capital Issue Committee (CIC), which was constituted in 1971 to address foreign repatriation of money realized from the stock market.

4.2.4.3 Retirement Benefits Authority

The retirement benefits pensions and provident funds were worth over Kshs 140 billion in assets as at end of year 2003. They were not regulated until 1997.

4.2.4.4 Kenya Bankers Association

KBA is an association of all commercial banks in Kenya, and is a self-regulating body on bank operational rules and procedures, which are set and honoured by the licensed banks themselves. It is a members association with its own articles of incorporation under the Companies Act.

4.3 Effects of policy and regulatory changes on performance

As policy, legal and regulatory reforms have been undertaken over time, the performance of Kenya's banking sector has improved considerably in terms of availability of services and profitability, among other performance indicators. However, access of the poor to affordable financial services, the cost of financial services, high level of borrowing by Government at the expense of the private sector, failure of banks to comply with licensing rules, high non-performing loans among a considerable number of banks, inadequate risk management mechanisms, and information technology risks, among others, remain notable challenges for the sector. Most of these are results of the information asymmetry problem cited earlier and inadequate competition in the sector.

This section assesses how the performance of the country's banking sector has evolved as the reforms described earlier took shape.

4.3.1 Corporate governance and international standards

Good corporate governance is very important, especially for foreign investors who may have information disadvantages (World Bank, 2005). Such governance could be promoted through increased transparency, use of international accounting standards, appointment of independent directors, stricter disclosure requirements and strong enforcement.

The Kenyan banking industry is quite advanced and sophisticated by regional standards, but has not attained international standards in several areas. Firstly, as noted earlier, banking supervision has yet to reach international standards, although substantial effort is being made by the Central Bank. Secondly, the country's national payment system does not meet most of the core principles of the Bank for International Settlements (BIS), mainly because many bank branches lack the appropriate equipment required for this and also because of the cash culture in the country. However, a strategy has been put in place to achieve BIS standards by the end of 2008.

Nevertheless, financial statements in the country are consistently prepared in accordance with International Accounting Standards and the Central Bank of Kenya Act since December 2003, when the International Accounting Standards Board issued implementation guidelines. Although the Council of the Institute of Certified Public Accountants of Kenya adopted such standards for financial reporting in 1998, lack of implementation guidelines and lack of a mechanism for providing interpretations hindered their use. The Central Bank has, in addition, introduced regulations about appointment of bank directors, strict disclosure requirements in the form of quarterly publication of the information on bank charges and other parameters in the media, and is increasingly strengthening enforcement.

4.3.2 Commercial performance

The banking sector in Kenya has grown tremendously since independence in terms of number of firms, assets, loans and advances, and deposits (table 4.3). As policy has changed, the number of firms has grown, especially since the 1990s.

Table 4.3. Kenya's banking sector performance, 1965–2004

	1965	1970	1975	1980	1985	1990	1995	2000	2004
No. of commercial banks	-	-	-	20	24	33	36	49	44
No. of NBFIs	-	-	-	23	48	51	43[42]	7	3
Total assets (K£ millions)	38.00	73.72	70.95	237.59	328.92	1,592.71	4,368.70	25,690	33,283
Loans and advances (K£ millions)	16.98	73.66	74.14	199.51	300.61	637.72	1,458.2	11,315	14,980
Deposit liabilities (K£ millions)	22.50	86.88	100.39	154.61	474.16	807.24	2,434.0	16,335	22,909
Savings deposit rate	-	4	5	5	12.5	17	15.73	4.51	2.77
Lending rates – (loans)	-	5.6	7	10	15	30	30.93	19.60	12.25
Spread (%)	-	1.6	2	5	2.5	13	15.20	15.10	9.50
Inflation rate (%)	3.5	7.5	17.8	12.8	10.8	15.8	1.6	10.0	11.6
Exchange rates, Kshs/$	-	7.14	8.26	7.57	15.78	24.08	55.94	76.18	79.17

Source: Kenya, *Economic Survey*.

The level of profits in the country's banking sector is very high, with banks being some of the most profitable companies in Kenya. Between 2002 and 2004, for example, total pre-tax profits for all commercial banks more than doubled, from Kshs 6 billion to 15.1 billion (table 4.4). Profitability in the banking sector arises from four main sources:

[42] In 1994, three NBFIs closed, two became commercial banks and three were placed under CBK's management.

(a) Interest earned from loans and advances less operating expenses, which are interest payment to depositors, provisions on bad debts and staff salaries;

(b) Interest earned from the purchase of government debt securities such as treasury bills and treasury bonds;

(c) Commission charges imposed on customers for services such as standing orders, banker's cheques, ATM services and ledger fees, among others; and

(d) Other earnings from trading, for example, in foreign currencies.

Table 4.4. Income and expenditure status of Kenya's banking sector, 2002-2004 (Kshs billions)

Income	**2004**	**%**	**2003**	**%**	**2002**	**%**
Interest on advances	25.5	41	27.9	44	28.7	45
Interest on government securities	7.6	12	10.3	16	11.8	19
Interest on placement	4.9	8	1.0	2	1.3	2
Other income	24.8	39	24.7	38	21.7	34
Total incomes	**62.7**	**100**	**63.9**	**100**	**63.5**	**100**
Expenses						
Interest expenses	6.5	10.4	8.5	13.3	13.0	20.5
Bad debts charge	7.6	12.2	8.4	13.2	11.1	17.5
Salaries and wages	14.9	23.8	14.8	23.3	15.9	25.0
Other expenses	18.5	29.5	18.1	28.3	17.5	27.6
Total expenses	47.5	75.9	49.8	78.0	57.5	90.6
Profit before tax	**15.1**	**24.1**	**14.1**	**22.0**	**6.0**	**9.4**

Source: Central Bank of Kenya, Bank Supervision Report 2005.

There is wide variability among the banks in terms of efficiency (cost/income ratio) and thus profitability, with banks having foreign shareholding performing much better (table 4.5).

Table 4.5. Cost/income ratio and market share for the top 10 banks, 2004

	Bank	**Ownership**	**Cost/income ratio**	**Market share**
1.	Barclays Bank of Kenya	Foreign and local	60.58%	18.43%
2.	Kenya Commercial Bank	Local	86.26%	12.05%
3.	Standard Chartered Bank	Foreign and local	57.82%	11.62%
4.	Cooperative Bank of Kenya	Local	91.54%	8.04%
5.	National Bank of Kenya	Local	82.62%	5.30%
6.	CFC Bank Ltd.	Local	86.28%	5.16%
7.	Citibank	Foreign	78.13%	4.35%
8.	Commercial Bank of Africa	Foreign and local	67.88%	3.49%
9.	National Industrial Credit	Foreign and local	67.74%	2.88%
10.	Investment and Mortgages	Local	63.65%	2.58%

Source: End year audited financial results.

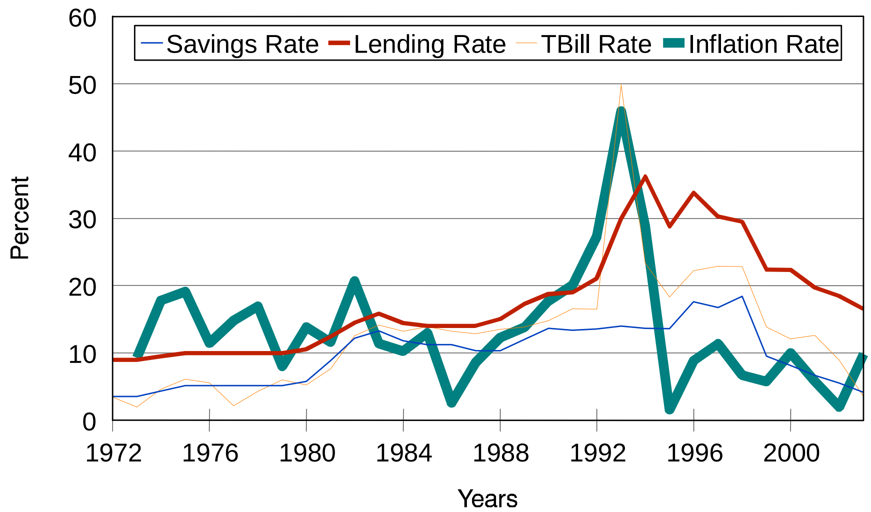
The public view is that the banks' profits are very high owing to very high charges for banking services. Against this background, the Government has given the CBK more autonomy to regulate the performance of financial institutions, license them, and also ensure that they do not overcharge their customers. Thus, the Minister of Finance has recently proposed invocation of section 44 of the Banking Act, which regulates the application of banking charges.

Banks in Kenya long relied mainly on interest income. This was especially so in the 1990s, when interest on treasury securities reached 70 per cent. With the decline in interest rates in recent years, banks have been forced to turn to non-interest income, including fees and commissions. They are doing this by introducing new, technology-driven, value added and innovative products and services. In addition, banks are now very aggressive in retail banking services, that is, issuance of personal loans and more recently small business credit. These loans are short term (up to a maximum of 36 months), unsecured loans, with the collateral being the pay slip, which also determines the maximum amount in loan an applicant can qualify for. Not surprisingly, therefore, consumer lending is now the second largest lending category after manufacturing.

4.3.3 Interest rates and spread

High interest rates have been a feature of Kenya's business environment for many years in spite of the country pursuing a policy of low interest rates and liberalization. In recent years, the country has made considerable gains with respect to falling interest rates (figure 4.1) due to stable macroeconomic conditions.

Fig. 4.1: Trends in Interest Rates and Inflation 1972-2003



Source: KIPPRA (2005a).

Even though major reforms have been introduced in the financial sector over time, the interest rate spread (the difference between lending and deposit rates) remains high (figure 4.1 and table 4.6).

Table 4.6. Interest rate (percentage), 2003–2004

Interest rates (%)	2003	2004 (January–December)											
Treasury bill rate	1.00	1.20	1.58	1.57	1.59	2.11	2.87	2.01	1.71	2.27	2.75	3.95	5.06
Overdraft rate	14.13	14.02	13.30	11.36	11.65	11.08	10.79	10.72	10.79	11.10	10.81	10.95	11.36
Interbank rate	0.69	0.73	0.82	0.90	1.27	1.72	2.05	1.29	1.52	2.07	2.95	3.56	4.66
Average lending rate (1)	14.75	14.07	13.48	12.69	13.12	12.67	12.55	12.17	12.31	12.19	12.27	12.39	
Average deposit rate (2)	3.13	3.32	3.12	2.47	2.32	1.96	2.22	2.20	2.25	2.25	2.63	2.33	
3-month deposit	2.56	3.17	2.66	2.17	2.15	2.02	2.27	2.14	2.17	2.18	2.22	2.43	
Savings rate	1.43	1.44	1.22	1.47	1.30	1.24	1.15	1.15	1.10	1.08	1.03	1.07	
Spread (1-2)	**11.62**	**10.75**	**10.20**	**10.50**	**10.80**	**10.71**	**10.33**	**9.98**	**10.06**	**9.93**	**9.64**	**10.5**	
*** 91 Days Treasury bill rate**													

Source: Central Bank of Kenya.

The problem has worsened over time. Thus, while the spread averaged about 3.6–5.8 per cent from 1979 to 1993, it had escalated to 13.8–13.3 per cent by 1994–2003 and stabilized at an average of 10 per cent. This shows that the country's financial sector is not yet competitive or efficient, and that access to affordable financial services is limited. The sector is still largely oligopolistic and characterized by high transaction costs and a large stock of non-performing loans.

Research results suggest that monetary policy drives the interest rates charged by commercial banks in Kenya, with the latter rising with tightening of monetary policy (KIPPRA, 2005b). High statutory requirements, moreover, push interest rates up, as they are an implicit tax.

4.3.4 Compliance with banking regulations and NPLs

While violations of single lending, insider borrowing, weak management and politically motivated lending have been the leading causes of bank failure in Kenya, the gradual strengthening of the Central Bank's regulatory authority and capacity has led to considerable improvement in recent years. Thus, for example, the CBK supervision report for 2004 shows that, in 2004, only six banks failed the test that bars lending of more than 25 per cent of the core capital to a single customer, compared with eight in 2003. The same report indicates that there were no cases of insider lending in 2004, down from six in 2003. The number of reported violations of licensing rules, moreover, fell from 31 in 2003 to 16 in 2004.

NPLs remain the biggest challenge for the Kenyan banking sector, constituting about 21 per cent of the sector's total advances (table 4.7). The problem has been reducing, however, from an average of 45 per cent of total loans in the 1990s, to 41 per cent in June 2001, and 20.5 per cent in 2004.

The problem of NPLs is greatest among banks with significant government shareholding. While the quasi-multinational banks like Barclays, Standard Chartered, and Citibank have done relatively well in the management of NPLs, locally owned banks with considerable government ownership such as National Bank of Kenya, Kenya Commercial Bank, Cooperative Bank and Consolidated Bank have been seriously affected by high NPLs.

Table 4.7. Non-performing loans in Kenya's banking sector, 2003–2004, Kshs billions

		November 2003	November 2004
1.	Total advances	285.8	348.50
2.	Specific provisions	34.6	38.70
3.	General provisions	2.8	3.8
4.	Total provisions (2 + 3)	37.4	42.5
5.	Net advances (1 minus 4)	248.4	306.0
6.	Total non-performing loans	72.7	71.30
7.	Net non-performing loans (6 minus 2)	38.1	32.60
8.	Value of securities (estimated)	31.7	31.80
9.	Net exposures (7 minus 8)	6.4	0.80
10.	**Total NPLs as % of total advances (6/1)**	25.4	20.50
11.	**Total provisions as % of NPLs (4/6)**	51.4	59.60
12.	Exposures as % of total NPLs (9/6)	8.8	1.1

Source: Central Bank of Kenya.

The problem of high NPLs is attributable to poor lending practices. Over the years, there were credit line directives issued by the Government. In addition to these, there is also (a) lack of credit assessment mechanisms; (b) over-reliance on specific clientele or sectors as clients; (c) weaknesses in the judicial system that delay financial contract enforcement; and (d) poor economic performance that affected the ability of firms and individuals to pay their loans. High NPLs make it difficult for banks to lower lending rates, thereby leading to the problem of high interest rate spreads. High NPLs also increase the reluctance of banks to extend new loans even to credible clients, thereby affecting access to credit by the private sector, particularly the SMEs. Other costs of high NPLs include reduction of customer confidence in the financial sector, reduced intermediation as banks resort to less riskier investments such as government securities, and reduction of bank profits as a result of increased legal fees and penalty charges.

The Central Bank of Kenya and Kenya Bankers Association are working hard to improve the risk assessment capacity and practice in the banking industry. The problem is huge, as only 17 of 48 financial institutions were found, by a CBK survey, to have adequate risk management systems.

These efforts need to be nurtured and strengthened, because empirical evidence shows that a strong legal environment and enforcement are critical for access to external finance and development of financial markets. Quoting a study of 37 countries, the World Bank (2005) reports that if a country improved its property rights protection from the 25th to the 75th percentile, its loan spreads would decline by 87 basis points.

In order to reduce risks facing depositors, credible and independent rating agencies to regularly monitor banks are crucial. Such agencies are now prevalent around the world, with commercial rating companies now rating 439 banks in 50 developing countries (World Bank, 2005).

4.3.5 Competition and service diversification

The level of competition in Kenya's banking industry is rather low, with the 10 largest commercial banks accounting for 72 per cent of all deposits in 2001 and 77.3 per cent in 2002 (Kenya, 2003). By 2004, they controlled about 74 per cent of the deposits and total assets (table 4.8).

Table 4.8. Customer deposits and assets for the leading 10 banks, 2004 *(*Kshs millions)

	Bank	Deposits	Total assets	
		2004	2004	2003
1.	Barclays Bank	80,449,000	106,486,000	96,914,000
2.	Standard Chartered Bank	56,585,485	67,113,927	64,111,358
4.	Kenya Commercial Bank	55,893,730	69,609,167	60,488,155
6.	Cooperative Bank of Kenya	35,151,287	46,433,933	32,394,178
5.	National Bank of Kenya	23,721,363	30,593,625	25,919,156
3.	Citibank N. A	19,513,291	25,108,292	28,332,721
10.	Commercial Bank of Africa	17,619,052	20,189,383	18,396,440
8.	C.F.C. Bank Ltd.	12,673,291	29,815,562	16,430,346
9.	National Industrial Credit	12,504,011	16,643,493	10,990,036
7.	Investment and Mortgages Bank	11,634,660	14,911,893	12,130,025
	Total Banking Industry	440,141,660	577,712,473	496,366,319

Source: End year audited financial results.

Several arguments have been advanced: (a) the industry has an oligopolistic structure; (b) the small number of dominant banks at the top does not collude but they also do not compete against each other aggressively; (c) the market is probably segmented between the big commercial banks, the small commercial banks and the NBFIs, with hardly any competition between segments. All the arguments are probably true to varying extents. What is important to underline is that competition is inadequate and that this is responsible for many problems such as high interest rates. The large number of SACCOs, however, is starting to provide significant competition to commercial banks for customers of different income levels.

Although Kenya has a well-diversified banking sector, some services have not been adequately developed yet. Thus, pension schemes have not incorporated the majority of the people in the rural areas and also the SME sector. Provision of long-term credit is also a major problem area, as the DFIs established by the Government at independence to play this role were compromised by weak financial sustainability and vulnerability to political interference. The DFIs established between the 1950s and early 1970s did a good job of providing long-term capital as intended until the 1970s. Indeed, they get the credit for the establishment of some of the leading businesses/industrial firms in the country today. There are also no specialized institutions such as for export and import financing. In the capital markets, initial public offerings have stagnated and the number of listed companies has dropped. The corporate bonds market is shallow. Although the listing of bonds in Kenya started in the mid-1980s, the market has hardly picked up. Thus, there are currently only 4 corporate bonds worth $96 million, compared with 130 such bonds worth $12.927 billion in South Africa (KIPPRA, 2005b). With respect to government bonds, 69 (worth $2.328 billion) are listed in Kenya, compared to 143 bonds (worth $60.961 billion) in South Africa.

There is a compelling case for fostering competition in the country's banking sector. Evidence presented by the World Bank (2005) points to some salient issues in this regard. Firstly, foreign banks can help to improve the efficiency and performance of domestic banks and reduce interest rate margins, can use their cross-border experience to introduce innovations, and have improved credit access for SMEs in countries such as Chile, Peru and Argentina. Secondly, other sources of finance such as public bond financing, NBFIs, pension funds and contractual savings, and commercial microfinance strengthen competition and should therefore not be overregulated or receive unfair tax treatment. It is also important to allow and facilitate the provision of microfinance by commercial banks, allow MFIs to graduate into licensed financial institutions, and facilitate sharing of credit information among players in microfinance, and to liberalize pension rules.

4.3.6 Technology: electronic banking

Technology is critical in banking, as it determines the cost of accessing good information and thus the severity of the information asymmetry information. It is therefore important to assess how well the Kenyan banking sector performs with respect to technology. Electronic or e-banking is the conduct of normal banking services using electronic infrastructure or technology. E-banking increases the speed of data flow, with banking transactions such as disbursement of loans/advances and production of management reports done at very high speed. Electronic banking has been necessitated by the rapidly changing business and legal environment, including globalization, the changing customer or client needs such as quick service and 24-hour service. Modern technologies used in electronic banking in Kenya include:

- Personal data assistant used to automate record keeping;
- Automated teller machines;
- Plastic money such as credit, debit, smart and magnetic stripe cards for use in many shopping outlets;
- Online banking that facilitates transactions from anywhere and at any time;
- Cell phone banking i.e. banking through cellular phones through Short Message Service (SMS) and other services; and
- Websites for marketing bank products, services and disseminating information.

Among other issues that interface the National Payment System with e-banking include:

- Use of electronic data interchange (EDI) in bank clearing;
- Sharing of ATMs;
- Use of SWIFT (Society World Wide Inter-bank Financial Transfer); and
- Encouragement of network and branchless banking.

Kenya's banking system is now characterized by widespread availability of online data through the ATMs. Most leading banks are networked and customers can access their account balances at many of their retail outlets. The large banks such as Barclays, Kenya Commercial, Standard Chartered, and National are leaders in installation of ATMs. They have branded ATMs, while the smaller banks (20 of them) have joint ATMs, which operate under a network called KENSWITCH.

Banks in the country have adopted the ATM technology with considerable ease in the last couple of years. Thus, by 2002 only three years after the technology was introduced, 200 ATMs were operational in the country. These were, however, connected to the telephone system and were prone to telephone failures (KIPPRA, 2005b). Currently, the ATM systems of some of the leading banks are connected to the less vulnerable VSAT technology. Previously, banks were denied this opportunity owing to controls in the telecommunications sector.

While a few years ago banks were offering only limited cash withdrawal services through ATMs, the services offered through this technology have increased considerably to include cash and cheque deposit, bank statement enquiries and issuance, cash withdrawal by the use of credit cards, payment of utility bills, and credit top ups for mobile telephones. To a large extent, ATMs have replaced banking halls and the bank charges are much lower.

4.3.7 Service to the rest of the economy

The banking sector plays a crucial role in serving other sectors of the economy. One major way it does this is through resource mobilization in terms of receiving deposits from savers and paying them an interest rate. This is what the sector then lends to the public and other sectors of the economy by charging a different interest rate. Evidence in other parts of the world has underlined this role. Thus, financial market development leads to faster growth in productivity and output, and a doubling of private credit as a share of GDP leads to an increase in average long-term growth of almost 2 per cent (World Bank 2005).

4.3.7.1 Resource mobilization

Table 4.9 shows that the sector has been improving in its effectiveness of resource mobilization, particularly as demonstrated by the increasing trend in the ratios of money supply and savings to GDP. There is considerable scope for further improvement in these areas, however.

Table 4.9. Consolidated accounts of the banking system (Kshs millions), 2000–2004

Liabilities	As at the end of:				
	2000	2001	2002	2003	2004
Money supply (M1)					
Demand deposits	75,927	84,681	96,187	138,305	147,870
Currency outside banks	43,466	45,345	53,895	55,550	62,729
Subtotal	119,393	130,026	150,082	193,855	210,599
Quasi-money (MS)					
Call deposits	18,456	19,658	20,698	19,277	19,463
Savings deposits	68,314	66,122	69,620	70,752	74,582
Time deposits	91,710	92,929	97,844	97,133	115,194

Sub-total	178,479	178,709	188,162	187,161	209,239
Money supply (M2)	297,872	308,735	338,244	381,016	419,838
Money supply (M2)/GDP, %	30.8	30.1	32.6	33.4	33.0
Quasi-money (NBFIs)	16,8140	14,258 -668	13,364 -875	14,100 0	12,923 -193
Broad money supply (M3)	314,686	322,325	350,733	395,116	432,568
Foreign currency deposits Broad money supply (M3X) Treasury bills holdings Broad money supply (M3XT) Other items (net)	44,961 359,647 64,780 424,427 105,156	45,209 368,132 81,172 449,304 103,853	54,051 404,784 109,079 513,863 109,824	56,056 453,023 114,024 567,047 114,577	78,859 511,426 130,014 641,441 132,862
TOTAL LIABILITIES	**464,803**	**471,985**	**514,608**	**567,600**	**644,288**
Gross domestic savings/GDP, %	6.7	5.3	4.9	6.2	8.1
Assets					
Net foreign assets % of domestic credit to: • Central Government • Other public bodies • Private sector	83,478 21.97 2.11 75.91	91,775 26.40 2.11 71.49	104,377 27.64 1.95 70.41	125,066 30.34 1.35 68.30	143,129 24.25 2.18 73.57
Total domestic credit	381,325	380,210	410,231	442,534	501,159
Total assets	**464,803**	**471,985**	**514,608**	**567,600**	**644,288**

Notes:

(a) Broad Money (M3) is money supplied by the Central Bank, Commercial Banks and NBFIs.

(b) The terms include currency outside banking institutions, deposits held by non-banking institutions with the Central Bank, all deposits as well as certificates of deposits held by the private and other public sectors with banking institutions. Excluded are the central Government, local Government and non-residents assets deposited with banking institutions.

(c) Broad Money (M3X) comprises M3 and foreign currency holdings by residents.

(d) Broad Money (M3XT) comprises M3X and Treasury Bill holdings by the non-bank public.

(e) Other items net include special drawing rights (SDRs) allocated by the IMF.

(f) Net foreign assets includes government reserve position in the IMF and deposits with crown agents.

(g) Treasury bill holdings by the non-bank public is not included in total liabilities of the banking system.

Source: Kenya (2005), *Economic Survey*.

The main sources of deposits in the country are non-profit institutions and individuals, private enterprises and non-financial public enterprises (table 4.10). In December 2003, these accounted for 48.7 per cent, 21.7 per cent and 7 per cent, respectively, of the total deposits. In May 2005, the respective shares were 44.4 per cent, 21.9 per cent and 5.7 per cent.

Table 4.10. Sources of deposits in the Kenyan banking sector, 2003–2005, Kshs millions

	Depositors	Dec. 2003	Dec. 2004	May 2005
1.	Central Government	7,578,659	10,270,567	16,060,197
2.	Local Government	1,193,206	938,708	1,644,474
3.	Non-financial public enterprises	26,672,957	25,990,097	26,450,495
4.	Financial public enterprises	2,296,112	2,683,678	2,417,512
5.	Commercial banks	1,223,512	2,133,271	3,845,177
6.	NBFIs	245,946	140,255	763,888
7.	Mortgage finance companies	1,973,545	721,499	1,637,232
8.	Building finance companies	172,941	2,646,696	1,492,443
9.	Cooperative societies	9,767,381	13,807,055	13,800,714
10.	Insurance companies	4,008,724	5,492,012	6,164,246
11.	Hire purchase companies	59,801	136,303	107,241

12.	Private enterprises	82,894,890	91,970,840	101,203,129
13.	Non-profit institutions and individuals	186,084,825	203,113,908	205,297,766
14.	Balance on foreign currency accounts	56,050,167	78,843,779	81,185,920
15.	Others	415,755	488,648	547,009
	Total	**382,194,621**	**439,377,316**	**462,617,443**

Source: Central Bank of Kenya.

4.3.7.2 Sectoral credit distribution

With respect to credit distribution, there was a worrisome trend in the period 2000–2003 when the share going to the public sector increased from 24.1 per cent to 31.7 per cent before falling to 26.4 per cent in 2004 (table 4.9). At that time, the share of credit to the private sector was declining. It is critical that a growing share of credit find its way into the private sector so as to spur economic growth. Table 4.11 shows the relative historical growth of credit allocation to various public and private sectors. It shows that the sectors that have been receiving an increasing share in relative terms include agriculture and manufacturing.

Table 4.11. Sectoral loans and advances, 1965–2004

Sector	1965	1970	1975	1980	1985	1990	1995	2000	2004
Central Government	0.827	0.085	0.210	0.232	0.05	58.98	63.53	3187	4980
Local Government	88	705	1,225	349	0.89	3.12	15.21	25	17
Enterprises, parastatal bodies and other public entities	-	2,420	9,221	16,871	86.73	157.50	246.83	378	577
Total public sector	**88.827**	**3,1251**	**10,656**	**17,452**	**87.67**	**219.60**	**325.57**	**3590**	**5574**
Private enterprises in agriculture[43]	6,276	9,287	36,848	102,361	136.47	300.73	723.91	1219.93	1540.35
Mining and quarrying	75	174	5,381	10,543	7.08	9.80	76.49	140.46	96.71
Manufacturing	8,299	15,581	41,926	128,280	180.34	450.97	1,608.18	2971.28	3150.20
Building and construction	1,078	3,371	10,865	36,224	51.81	121.71	304.58	842.50	880.76
Transportation, storage and communication	701	2,955	7,159	28,231	27.45	84.01	329.71	480.42	1009.70
Trade (exports/imports/domestic)	22,953	33,786	54,378	119,299	206.79	355.68	1,089.89	2075.00	2179.07
Financial institution	4,467	2,732	6,400	16,288	41.65	49.75	162.10	266.20	382.05
Other business	7,057	6,560	34,295	116,232	144.62	422.88	1,691.51	-	-
Total private enterprises	**50,906**	**74,446**	**19,252**	**557,459**	**796.21**	**1,795.53**	**5,986.37**	**11242.8**	**12443.8**
Community and personal services	2,902	7,581	21,957	36,360	36.45	57.95	244.82	405.17	1807.40
Total bills, loans & advances	**54,110**	**86,940**	**259,000**	**657,930**	**1,053.89**	**2,073.08**	**6,555.76**	**13025.8**	**17430.6**

Note: Figures are in K£ thousands for the period 1965–1980 inclusive and K£ millions for the other years.
Source: Kenya, *Economic Survey* (Various).

A closer look at the sectoral distribution of credit to the private sector in the last three years shows the leading sectors are manufacturing, trade, households and finance and insurance. In December 2003, these four sectors jointly received 55.1 per cent of total loans to the private sector, while the respective share had reached 56.87 per cent in May 2005 (table 4.12). The striking trend in the last three years is the increase in the share of credit going to private households and consumer durables, which rose from 11.64 per cent in December 2003 to 16.45 per cent in May 2005.

There are segments of the economy that are marginalized in terms of access to financial services. The first is SMEs, especially following rationalization and privatization processes. This sector is

[43] Agriculture includes forestry, fishing and wildlife.

very important in the Kenyan economy, estimated to contribute 18 per cent of the GDP and 72 per cent of employment. It is estimated by various studies quoted in KIPPRA (2005b), however, that only 4–10 per cent of the sector's demand for credit is met. In a 1998–1999 survey, only 3.2 per cent of these enterprises had ever accessed credit from the formal financial institutions.

Table 4.12. Loans to the private sector, 2003–2005, Kshs millions and share (%)

	Sector	Dec. 2003		Dec. 2004		May 2005	
		Kshs, m	%	Kshs, m	%	Kshs, m	%
1.	Agriculture	24,470	9.22	30,072	9.10	28,951	8.42
2.	Manufacturing	52,746	19.86	63,314	19.17	65,300	19.00
3.	Trade	44,204	16.65	47,937	14.51	54,219	15.77
4.	Building and construction	19,439	7.32	20,075	6.08	22,909	6.66
5.	Transport and communications	16,757	6.31	20,290	6.14	26,218	7.63
6.	Finance and insurance	24,596	9.26	27,566	8.35	29,803	8.67
7.	Real estate	19,372	7.30	20,229	6.12	22,981	6.69
8.	Mining and quarrying	1,493	0.56	1,943	0.59	2,193	0.64
9.	Private households	24,774	9.33	38,229	11.57	46,167	13.43
10.	Consumer durables	6,134	2.31	5,946	1.80	10,398	3.02
11.	Business services	22,055	8.31	25,038	7.58	32,421	9.43
12.	Others	3,496	1.32	29,701	8.99	2,215	0.64
Total		**265,535**	**97.75**	**330,340**	**100.0**	**343,776**	**100.0**

Source: Central Bank of Kenya.

The sector relies heavily on the non-traditional financial service providers such as KPOSB, SACCOs and MFIs, a sector characterized by a weak regulatory environment. The reasons why the formal banking institutions do not extend credit to the SME sector include lack of prior lending experience to the sector, and a belief that such lending would be risky and costly. Even SMEs find the costs of formal banking services high and therefore rely on informal institutions (KIPPRA, 2005b).

4.3.7.3 Geographical credit distribution

The other marginalized segment of the economy is the rural sector in general. While about 13,000 people share a bank branch in Nairobi, 272,500 have to share a branch in the North-Eastern province (table 4.13). This was marginalized following government divestiture in the banking sector and rationalization of banks through consolidation and closure of branches that were not making profits. As the table shows, SACCOs have generally improved access except in the North-Eastern province and, if allowed to extend credit, KPOSB has even greater potential.

Table 4.13. Geographical distribution of financial institutions branch network, 2001–2004

Province	2001	2002	2003	2004	% Change
Central	69	69	69	71	2.9
Coast	69	70	69	72	4.3
Eastern	35	34	36	39	8.3
Nairobi	192	166	204	212	3.9
N. Eastern	4	4	4	4	0.0
Nyanza	40	38	40	40	0.0
Rift Valley	67	67	71	75	5.6
Western	18	18	19	19	0.0
Total	**494**	**466**	**512**	**532**	**3.9**

Source: Central Bank of Kenya, Supervision Annual Report 2005.

Credit information institutions are very important to improve loan repayment and reduce default rates, and thus increase lending, and reduce transactions costs for small and new firms. Empirical evidence indicates that countries without such institutions have a private credit/GDP ratio of about 16 per cent compared with about 40 per cent for countries with publicly-owned credit registries and about 67 per cent for those with private credit information bureaus (World Bank, 2005). It is therefore important for the Government to enact and enforce data protection and credit reporting laws that allow sharing of this important information.

4.3.7.4 Employment and poverty alleviation

Developed financial markets reduce poverty directly and by increasing economic growth. Quoting evidence from various studies, World Bank (2005) identifies several channels through which financial market development reduces poverty:

- Reducing income inequality by alleviating credit constraints and increasing access to investment opportunities for poor households;
- Reducing exploitation of poor households by facilitating competition between firms that purchase goods produced by the poor households;
- Stabilizing the economy by reducing volatility (Doubling private credit as a share of GDP has been found to reduce volatility of growth from 4 per cent to 3 per cent annually.); and
- Reducing child labour, which has been found to be lower in countries with greater access to financing.

The material presented in the previous sections of this chapter shows clearly that there are still enormous credit access bottlenecks, especially for the poor, that competition is inadequate, and that the share of private credit in GDP, though increasing, is not enough. The banking industry in Kenya employs about 12,000 people. However, nearly 7,000 of them are clerks and supervisors, while only about 3,000 are managers (table 4.14).

Table 4.14. Employment in the banking industry, 2003–2004

Category	2003		2004		Increase	
	No.	%	No.	%	No.	%
Management	3,097	27.6	3,165	26.5	68	2.2
Supervisory & sec. Heads	2,564	22.6	2,743	22.9	179	7.0
Clerks & secretarial staff	4,861	42.9	5,130	42.9	269	5.5
Other categories	809	7.1	903	7.7	94	11.6
Total	**11,331**	**100.2**	**11,941**	**100.0**	**610**	**26.3**

Source: Central Bank of Kenya, Supervision Report 2005.

Besides employment, the banking industry has also contributed to poverty alleviation in Kenya by creating awareness about the need and providing the means for savings. In this way, many people in the country have been able to save and cater to critical needs such as paying school fees and dowries, buying "*boda boda*" bicycles for informal business, and other important expenditures. Many people are also able to borrow from banks, as collateral requirements have become a minor bottleneck. The Government, moreover, earns corporate and other taxes from the profitable banks, thereby obtaining resources to build hospitals, schools and other infrastructure for the poor. Training remains an important component of staff development process in the banking industry. While each bank trains its own staff, the Kenya School of Monetary Studies remains the premier training centre on banking and other related courses. The large banks however, mainly use their local training schools to train their staff while the small and medium-sized banks mainly use the training facilities offered at the Kenya School of Monetary Studies.

What this suggests, therefore, is that there is still substantial room for improvement for the Kenyan banking sector to maximize its contribution to employment creation and poverty alleviation.

4.3.7.5 Trade in banking services

In spite of Kenya's regional comparative advantage in skills and human resources, and its well developed banking industry, the country hardly exports banking services even in the region. It is notable, however, that one of the country's largest banks, Kenya Commercial Bank, has opened branches in East Africa and is seeking to enter the south Sudanese market. The other main source of financial services exports occurs when tourists consume banking services and through correspondence banking.

4.3.7.6 A comparative note

In this note, we compare the strength of Kenya's banking sector with those of selected countries in Africa. We then compare the performance of different types of banks within the country.

Kenya vs. selected African countries

In comparison with a selected number of other African countries, Kenya does fairly well with respect to the degree of monetarization of the economy (as measured by broad money supply (M3) as a proportion of GDP), proportion of total domestic credit that goes to the private sector, and ratio of stock market capitalization to GDP (table 4.15). It performs relatively poorly, however, with respect to the interest rate spread, indicative of its relatively low competitiveness and inefficiency. In all these indicators, except the degree of government intervention (financial repression), South Africa outperforms Kenya.

Table 4.15. Financial development indicators for selected African countries, 1980–2002

Country	Private credit/total domestic credit	Monetarization of economy	(Lending–deposit) interest rate	Financial repression	Stock market capital/GDP
Botswana	0.3408	0.2817	3.5626	-0.7500	0.152
Egypt	0.3552	0.8166	4.9232	-0.7207	0.1210
Ghana	0.2313	0.1702	-10.498	-0.5704	0.1483
Kenya	**0.5856**	**0.3687**	**7.8464**	**-0.6465**	**0.1422**
Nigeria	0.5411	0.2504	5.3429	-0.5309	0.0487
South Africa	0.9412	0.4524	4.2159	-0.7547	1.4049
United Rep. of Tanzania	0.2579	0.2640	12.9283	-0.6175	0.0304
Uganda	0.3998	0.1201	1.5550	-0.4788	0.0071
Zimbabwe	0.5449	0.2527	9.3426	-0.4930	0.3249

Source: KIPPRA (2005b).

Again relative to selected African and Asian countries, Kenya performs well with respect to the percentage of small firms with a loan and, to some extent, the size of domestic credit provided by the banking sector as a percent of GDP (table 4.16). However, the country performs very poorly in terms of the percentage of firms finding finance a major constraint.

Table 4.16. Further comparative analysis of Kenyan financial services within Africa and Asia

Country	% of firms reporting finance as a major constraint	% of small firms with a loan	Domestic credit provided by banking sector (% of GDP)	
			2002	2004
India	19.2	51.1	58.5	59.9
Kenya	**58.3**	**59.3**	**43.2**	**40.8**
Malaysia	17.8	57.3	154.2	134.3

South Africa	-	-	147.5	84.5
United Rep. of Tanzania	53.0	13.3	10.0	9.2
Uganda	52.8	14.1	15.4	11.0

Source: World Bank (2005, 2006); *World Development Report 2005, 2006*.

4.4 Market opening, financial stability and capital movements

It is generally accepted that liberalization of financial services increases competition and reduces monopoly powers in the long run, which improves allocation of capital and facilitates access to cheaper resources. Commitment of financial services within the framework of GATS/WTO, it is further believed, signals actual financial and banking policies, thereby affording economic agents greater certainty and stability. GATS negotiations on financial services led to an interim agreement in 1995 and final agreement in 1997. In 1995, Kenya did not make any commitments in the sector but had done considerably so in 1997, thereby entrenching the liberal nature of banking.

The country's schedule of specific commitments in banking is presented in table 4.17. As the table shows, the specific banking services the country committed include (a) acceptance of deposits; (b) all types of lending, including various forms of consumer credit, mortgage credit and financing of commercial transactions; (c) all payments and money transmission services; (d) guarantees and commitments; (e) securities and provision of related services except underwriting services; (f) asset management except pensions fund management; and (g) advisory and other auxiliary financial services.

The commitments are considerable in comparison with those made by other countries. Thus, in a range of 0–1, Kenya scored an average 0.10 in all financial services and 0.18 in banking services (Valckx, 2002).[44] Comparative scores with respect to banking services included 0.54 for the European Union, 0.21 for the United States, and 1.00 for Malawi (one of the most "committed" African countries) (Valckx, 2002). A major feature of the Kenyan schedule is that national treatment is considerably unbound, especially with respect to commercial presence and cross-border trade.

Table 4.17. Kenya's schedule of specific GATS commitments in banking

Supply modes: (a) cross-border; (b) consumption abroad; (c) commercial presence; (d) presence of natural persons

Sector or subsector	Limitations of market access	Limitations of national treatment
A. Banking and other financial services (excluding insurance) (a) Acceptance of deposits and other repayable funds from the public	(1) None (2) None (3) Only institutions approved as banks under the Banking Act 4) Unbound, except as indicated in the Horizontal Commitments	1) Unbound 2) None 3) Unbound 4) Unbound, except as indicated in the Horizontal Commitments
(b) Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction	1) None 2) None 3) None 4) Unbound, except as indicated in the Horizontal Commitments	1) None 2) None 3) Unbound 4) Unbound, except as indicated in the Horizontal Commitments

[44] It should be noted, however, that some authors rank Kenya among the countries that have liberalized their banking sector completely. These include Qian (2000) and Mattoo (Undated).

(c) All payments and money transmission services	1) None 2) None 3) None 4) Unbound, except as indicated in the Horizontal Commitments	1) None 2) None 3) Unbound 4) Unbound, except as indicated in the Horizontal Commitments
(d) Guarantees and commitments	1) None 2) None 3) None 4) Unbound, except as indicated in the Horizontal Commitments	1) Unbound 2) None 3) Unbound 4) Unbound, except as indicated in the Horizontal Commitments
(e) Participation in issues of all kinds of securities and provision of services related to such issues except underwriting	1) Securities issued in a foreign jurisdiction cannot be offered or traded in Kenyan market 2) None 3) Foreign portfolio investors can hold up to 40% of the shareholding of a locally listed company. They can also take up to 40% of any additional public offering by a foreign convened listed company. 4) Unbound, except as indicated in the Horizontal Commitments.	1) Unbound 2) None 3) Unbound 4) Unbound, except as indicated in the Horizontal Commitment.
(f) Asset management except pension fund management	1) None 2) None 3) 30% of paid up capital must be held by Kenyan nationals 4) Unbound, except as indicated in the Horizontal Commitments	1) None 2) None 3) Unbound 4) Unbound, except as indicated in the Horizontal Commitments
(g) Advisory and other auxiliary financial services	1) Unbound 2) Unbound 3) One third of paid up capital must be owned by Kenyan nationals 4) Unbound, except as indicated in the Horizontal Commitments	1) None 2) None 3) Unbound 4) Unbound, except as indicated in the Horizontal Commitments

Source: WTO website.

Requests for further commitments

Under the ongoing GATS 2000 negotiations, Kenya has received several requests, mainly from the European Union and the United States, to liberalize its financial sector further. In banking and other financial services, the requests include (a) full commitments (in modes 1, 2 and 3) in provision and transfer of financial information and for trading of negotiable instruments and other financial assets, underwriting of securities, money brokering, pension fund management, settlement and clearing services; and (b) full commitments (in mode 3) in acceptance of deposits and other payable funds from the public, and participation in issue of all kinds of securities and provision of services related to such issues.

4.4.1 Impact of liberalization and commitment

There is considerable empirical evidence, from developed and developing countries, that liberalization contributes to both banking and currency crises in the short and medium terms (Kaminsky and Reinhart, 1999; Wyplosz, 2001). Liberalization increases risk-taking, which may become excessive in an environment of inadequate supervision and regulation. Literature shows that large capital inflows, such as might result from lifting of external restrictions, tend to be followed by sudden outflows leading to exchange rate volatility. In addition, most recent studies find no or little evidence that financial liberalization leads to financial development or faster growth (Wyplosz, 2001). Instead, financial liberalization could contribute to macroeconomic instability,[45] with a boom–bust cycle detected for developing countries (Wyplosz, 2001). This leads to inequality (at least initially) because such cycles affect the poorer and less educated segments of the population more. The World Bank (2006) also notes that, although an open and liberalized financial system promotes access, innovation and growth, if privatization and liberalization are done rapidly before the regulatory capacity is strengthened, they could lead to highly concentrated benefits, such as happened in Chile in the 1970s, Mexico in the 1980s and the Russian Federation in the 1990s. The reports notes, "Rapid or premature liberalization in a context of low political accountability can increase financial fragility, and the risk of opportunistic default… It can also lead to reform backlash because of unfair distribution of the costs and benefits of such liberalization".[46]

Some of the advantages of financial controls include flexibility to insulate domestic interest rates, reduction of the proportion of short-term capital in the capital flows, flexibility to defend attacks on the exchange rate, and flexibility to contain currency crises (Dooley, 1996; Eichengreen and Mussa, 1998; Rossi, 1999).

The supply mode and type of financial service committed within GATS is an important determinant of whether or not financial services liberalization affects financial stability (Ikiara et al. 2003). Valckx (2002) finds that if the commitments are more on mode 3 rather than 1, there is a higher likelihood of banking problems but lower risk of a currency crisis. Moreover, there is greater risk if banking and securities services (as opposed to insurance) are committed. Kenya's commitments are more on mode 1 relative to mode 3, suggesting the country could be more vulnerable to currency crises.

Kenya has communicated, within the GATS framework, its need for a strong and transparent regulatory regime and efficient supervisory body before further liberalization of financial services is undertaken. The wisdom of this is evident from the above empirical evidence. There is need for the country to build proper economic and political infrastructure, and welfare systems, before financial liberalization, and for capital account liberalization to be undertaken several years after domestic financial liberalization (Wyplosz, 2001). Commitments should be properly sequenced and there should be adequate supervisory and regulatory framework (Valckx, 2002).

Prudential regulation

The GATS annex on financial services allows WTO member countries to take prudential measures, even when they have made commitments, such as those intended to protect investors, depositors and policyholders, or the integrity and stability of the financial sector. Such prudential measures include capital adequacy requirements, restrictions on credit concentration or portfolio allocation, disclosure and reporting requirements, and licensing requirements. While the conduct of government policy such as monetary policy has effects on the financial sector, moreover, such exercise of governmental authority is not covered by GATS. Domestic regulations such as requirements for financial institutions to lend to specific sectors or individuals are permitted as long as they are objective and impartial.

[45] The peak-trough output gap differential is found to exceed 20 per cent in the case of capital account liberalization.
[46] Page 182.

Kenya liberalized its financial sector, largely under the structural adjustment programme of the Bretton Woods institutions, before building adequate supervisory and regulatory capacity. The Central Bank lacked the autonomy required for this capacity development. This contributed to several bank crises, as discussed earlier.

4.5 Opportunities and challenges in the sector

4.5.1 Opportunities

Since the present Government came into power in December 2002, some degree of confidence has come in and stabilized interest rates in the country. As a consequence, loans and overdrafts are not as expensive as they were in the early 1990s. Furthermore, since the Government is not borrowing much through treasury bills, the commercial banks are now left with more loan-able funds, which is a considerable boost to the private and SME sectors.

Another opportunity in the banking industry is associated with improvement of bank supervision by the Central Bank. Bank charges, for instance, are now displayed in the banking halls and printed in the local dailies every month. By informing the general public, this improves competition and puts pressure on the banks to maintain low bank charges.

The licensing of microfinance institutions and allowing cooperative societies to open front offices for the purpose of offering normal banking services at affordable charges to their members is already offering significant competition to commercial banks, as there are over 6,000 SACCOs spread across the country. The SACCOs are taking deposits, issuing personal loans, and facilitating payment of salaries to teachers and other junior workers, a role played by the banks for many years. While SACCOs are making considerable profits from such front office operations, there is risk of the deposits due to lack of adequate protection. Enactment of required laws and regulatory frameworks is likely to be facilitated by the prevailing reform environment.

4.5.2 Challenges

In spite of the considerable reforms that have been made in Kenya's financial sector, many challenges still affect the delivery of efficient and affordable services to Kenyans. Some of the challenges that have faced the sector either in the past or currently include:

(a) Many NBFIs, which were locally owned, collapsed due to poor management, lack of entrepreneurial skills and under-capitalization.
(b) In the 1980s and 1990s the Central Bank lacked the autonomy required to effectively regulate the industry.
(c) Political and economic uncertainties affected the development of some subsectors such as the stock exchange.
(d) There has been cyclical and high interest rates and inflation, especially in the 1990s. Consequently, the interest rate spread in Kenya is much higher than in South Africa and Mauritius, indicative of a less competitive financial sector in the country.
(e) Inadequate competition in the banking sector continues to hurt consumers of banking services in the country because of high costs, inefficient services, and higher risk among smaller banks as they adopt survival tactics to cope with domination of a few large banks. According to KIPPRA (2005b), the factors that continue to hinder competitiveness in the Kenyan banking sector include underdevelopment of credit rating institutions and capital markets, and high prevalence of non-banked clients,

especially the SMEs. Financial assets available in the country are not diversified enough and there is inadequate public knowledge of even the existing ones since the country does not have public credit institutions to supply such information.

(f) Non-performing loans were a major problem in the late 1990s and early 2000s and still are. By 2001, NPLs accounted for 40.3 per cent of the total loans advanced, although this had declined to about 21 per cent by 2004. This problem was caused by poor lending practices, and political and other external interference. Bank profits declined due to high NPLs. Between 1997 and 2000, for instance, bank profits declined from Kshs 15.8 billion to 2.4 billion (KIPPRA, 2005b). By 2004, however, pre-tax profits reached Kshs 15 billion, the highest since the late 1990s.

(g) Low client base for indigenous banks, mainly local investors (characterized by a low investment rate) was due to the bank's relatively smaller size and bad reputation with respect to stability.

(h) Low credit was extended to the private sector, as a result of constraints in access to and high cost of credit. Thus, while the private sector credit ratio in Kenya averages only 55 per cent, the ratio is over 95 per cent in South Africa and over 80 per cent in Mauritius (KIPPRA, 2005b). A recent survey of the Kenyan manufacturing sector indicated that only 17 per cent of manufacturing firms use bank loans, the majority of the others relying on internal funding (KIPPRA, 2005b). The KIPPRA study shows that the reasons demand for credit is low include the fact that the main collateral (92 per cent) is immovable property, and the long time it takes to process loans (average of 11 weeks and a maximum of 104 weeks) or decide on the loan application (average of 24 weeks and a maximum of 52 weeks).

(i) Poor segments of the economy have been marginalized from the formal banking system, leading to increased demand for informal services. Thus, besides cooperatives establishing front office operations, informal rural banks are sprouting and there is considerable pressure on the Government to formalize the operations of microfinance institutions. In addition, with bank rationalization and divestiture of Government in the sector, the outreach of banking services, especially in the rural areas, is declining considerably. The remaining bank branches, moreover, are not evenly distributed in the country.

(j) Although Kenya has a well-diversified banking sector, some services have not been adequately developed yet. These include pension schemes, long-term credit, export and import financing, and the capital market.

(k) Despite the major role MFIs play in serving marginalized segments of society, they face numerous challenges, including lack of attention within the country's economic agenda. Yet the mainstream financial system serves only 10 per cent of the Kenyan population, with limited outreach, especially in rural areas, due to (a) problems of infrastructure and insecurity; (b) poor economic performance of the rural economy; (c) lack of capital, owing largely to legal hindrances to MFIs mobilizing savings and providing an intermediation service; (d) lack of regulation and supervision; (e) weak governance and management structures; (f) lack of sector performance standards to earn credibility; (g) weak institutional capacities; (h) low financial literacy among Kenyans and thus weak demand; and (i) existence of illegal money lenders who the customers take for MFIs (KIPPRA, 2005b).

(l) Serious challenges set in for DFIs after the 1970s, including poor management, largely because of (a) political considerations in the hiring of boards of directors and management; (b) political interference with investment decisions and even loan recovery efforts of the DFIs; (c) inability to raise funds without government guarantee when this was withdrawn in the 1990s; (d) poor economic performance, especially in the 1990s, that led to poor projects being supported by DFIs; and (e) a burdensome regulatory framework with each DFI having a separate act of Parliament but still being subjected to State Corporations Act, direction of their parent ministry, the Ministry of Finance and the Office of the President (KIPPRA, 2005b).

4.6 Conclusions

4.6.1 Main steps to ensure efficiency, viability and sustainability of banking services

To ensure short- and long-term efficiency, viability and sustainability of banking services in Kenya, the investment or business climate/environment has to be improved. The **first main step** in the improvement of this environment is demonstration of political will and commitment in the repayment of loans that have been non-performing due to political factors.

The **second main step** is the development of a comprehensive financial sector development strategy that recognizes the varied needs of the diverse clientele in the country, the supply constraints largely caused by inadequate competition in the banking industry, the role that foreign firms can play and how they need to be organized or directed to play that role, and the regulatory and supervisory capacity and needs including optimal regulation of service providers in ways that recognize the tradeoff between market failures and government failures, among others. The development of this strategy is already ongoing.

The **third main step** is to (a) strengthen existing institutions, particularly the Central Bank and DFIs; (b) establish those required for improving performance and services, such as public credit institutions; and (c) carry out the required legal and regulatory reforms. In particular, the Microfinance Bill and SACCO Regulatory Bill should be finalized and enacted and the Post Office Bank of Kenya Act reviewed to allow it to extend credit to its customers. These pieces of legislation should include explicit disclosure and accountability requirements to improve the confidence of local users. In addition, laws allowing collateralization of movable property and establishment of registries (possibly electronic), are required to facilitate credit access for small firms that lack fixed assets. Likewise, it is important for the Government to enact and enforce data protection and credit reporting laws that allow sharing of credit information. Credible and independent rating agencies that regularly monitor banks are also crucial. The privatization bill also needs to be finalized and enacted to guide the Government in further divestiture from the banking industry, as does the Central Depository System Act to improve investor confidence and liquidity.

This step should also involve provision of incentives to the private sector to (a) stimulate better outreach; (b) broaden the assets that could be used as collateral, establish and deepen banking services that are currently lacking or are thin and shallow; and (c) reduce banking charges. This step should include deliberate government actions to promote further development of bonds and stocks markets, DFIs and other institutions required to mobilize long-term capital, and local banks and other institutions required to serve the specific needs of the marginalized sectors, mainly the rural population and the micro, small and medium enterprises.

There are several other ways in which access to banking services can be increased:

- Innovative use of existing infrastructure or networks, such as the extensive post office infrastructure, mobile banking, kiosks, small branches and joint ventures with non-bank institutions. This helps to reduce the transactions costs of handling small volumes and the cost of expanding outreach. The regulatory changes required to facilitate such innovations are therefore critical.
- Improvement of political and regulatory accountability through facilitation of the public scrutiny role of the private sector, civil society, and independent and technically competent non-governmental agencies. This can be further enhanced by formal regulatory structures.

4.6.2 Role of trade conditions in promoting domestic banking capacity

The GATS agreement on financial services is quite flexible in that it allows countries that have made commitments to take prudential measures, formulate and implement the requisite policies, and even impose universal service obligations to foreign suppliers of financial services, so long as this is not discriminatory between foreign and domestic suppliers.

Greater commitments by Kenya, especially with respect to national treatment, can make existing players behave more competitively just by the virtue of the guarantee that barriers would not be re-introduced. This should be complemented by commitments that encourage new entry in order to increase competition in the formal banking sector. Greater commitments should be considered, as this does not take away the Government's authority to impose universal service obligations and necessary prudential measures. This should, however, be balanced against the need to retain some bargaining chips for future multilateral negotiations. It should also be tempered by the fact that privatization and liberalization need to be gradual, as regulatory and supervisory capacity is strengthened through greater public disclosure requirements, protection of minority shareholders, and allocation of more autonomy and power to the Central Bank and other regulators such as the Capital Markets Authority and the Retirement Benefits Authority.

4.6.3 Other necessary forms of international support or complementary actions

Besides enabling trade conditions, other forms of international support or complementary actions are required to ensure short and long term efficiency, viability and sustainability of banking services in the country. These include:

- Reduction of the risk of financial crises through improvement of full information disclosure internationally;
- Development of mechanisms to control or restrict capital flows to emerging markets;
- Technical assistance with respect to management of non-performing loans;
- Development assistance to develop sectors such as MFIs to not only serve the marginalized segments of the society, thereby helping the achievement of Millennium Development Goals, but also to increase the overall level of competition in the country's financial sector; and
- Improved donor coordination for effectiveness, especially in the MFI sector.

4.6.4 Steps, rules and commitments necessary to ensure gradualism and flexibility of banking liberalization

Going by the commitments that Kenya has already made in the financial sector, within the GATS framework, further liberalization should be progressive. Further liberalization and commitments before strengthening of the regulatory capacity could expose the country to greater risk of financial and currency crises. To prepare the industry and regulators for greater liberalization in the future, commitments to future liberalization should be considered. An example of this would be committing to the removal of national treatment limitations that currently exist in less than 10 years. This can help to speed up domestic reforms.

Empirical research to assess the impact of GATS commitments and other liberalization on the country's financial sector could help policy makers to be more decisive over the extent and speed of liberalization. Financial and technical support to facilitate this is therefore critical.

Annex 1
Annex table 1.1.
Wage employment by industry in Kenya, 1980–2004

Industry	1980 No. (1000)	1980 %	1990 No. (1000)	1990 %	1995 No. (1000)	1995 %	2000 No. (1000)	2000 %	2002 No. (1000)	2002 %	2004 No. (1000)	2004 %
Agriculture and forestry	231.4	23.0	269.7	19.1	294.0	18.9	312.2	18.4	313.6	18.5	320.6	18.2
Mining and quarrying	2.3	0.2	4.1	0.3	4.7	0.3	5.3	0.3	5.2	0.3	5.6	0.3
Manufacturing	141.3	14.0	187.7	13.3	204.8	13.1	218.7	12.9	229.8	13.5	242.0	13.7
Electricity and water	10.1	1.0	22.4	1.6	22.9	1.5	22.7	1.3	21.3	1.3	20.8	1.2
Building and construction	63.2	6.3	71.4	5.1	76.4	4.9	78.6	4.6	76.5	4.5	77.4	4.4
Wholesale & retail trade, restaurants and hotels	70.5	7.0	113.9	8.1	134.9	8.7	155.5	9.2	157.5	9.3	168.0	9.5
Transport & communications	55.2	5.5	74.5	5.3	79.1	5.1	84.2	5.0	85.5	5.0	98.3	5.6
Finance, insurance, real estate & business services	39.7	4.0	65.3	4.6	78.0	5.0	85.0	5.0	83.2	4.9	85.1	4.8
Community, social and personal services	392.1	39.0	600.3	42.6	662.2	42.5	733.1	43.2	726.9	42.8	745.8	42.3
Total wage employment	1,005.8	100.0	1,409.3	100.0	1,557.0	100.0	1,695.4	100.0	1699	100.0	1763.7	100.0
Total services	**557.5**	**55.4**	**854.0**	**60.0**	**954.2**	**61.3**	**1,057.8**	**62.4**	**1,053.1**	**62.0**	**1,097.2**	**62.2**

Source: **Kenya, *Economic Survey* (various issues).**

Annex table 1.2. Kenya's current account and the role of services, 1980–2004

	1980				1985				1990				1995			
	Credits	**%**	**Debits**	**%**	**Credits**	**%**	**Debits**	**%**	**Credits**	**%**	**Debits**	**%**	**Credits**	**%**	**Debits**	**%**
Visible balance	461.0	56.4	976.8	85.1	774.0	55.4	1,219.4	77.9	1,157.8	37.9	2,297.6	63.9	4,822.4	53.0	6,787.2	67.0
Invisible balance	356.1	43.6	171.4	14.9	622.9	44.6	346.8	22.1	1,894.5	62.1	1,298.9	36.1	4,274.3	47.0	3340.3	33.0
Total current account	817.1	100	1,148.2	100	1,396.9	100	1,566.2	100	3,052.3	100	3,596.5	100	9,096.7	100	10,127.6	100

	2000				2004			
	Credits	**%**	**Debits**	**%**	**Credits**	**%**	**Debits**	**%**
Visible balance	6,788.1	47.6	11,593.7	76.4	10,799.1	55.7	17,102.5	81.9
Invisible balance	7,484.0	52.4	3,582.8	23.6	8,605.2	44.3	3,779.3	18.1
Total current account	14,272.1	100	15,176.6	100	19,404.3	100	20,881.8	100

: Kenya, *Economic Survey* (various issues).

Annex 2
List of people interviewed

Central Bureau of Statistics, Deputy Director (Collins Opiyo)

Office of the President, E-Government Directorate (Oketch)

Communication Commission of Kenya (Njoroge, Liston Kirui, Matano Ndaro)

Kenya Revenue Authority, Director Research (Okello)

Ministry of Trade and Industry, WTO-Desk (Kamanu)

National Commission Secretariat (Charles Owino Ngesa)

Ministry of Information and Communication (David Ochieng)

Kenya Information and Communication Technology Association (Charles Nduati)

Annex 3
List of telecommunications operators and service providers

	Facility-based public telecommunications service providers	
	Regional telecom operators (**regional carrier**)	1
	Long-distance telecom operators (**interregional carriers**)	1
	International Telecom Operators (**international carriers**)	1
	Local loop providers (**local loop operators**)	9
	Cellular mobile telephone service providers (**mobile operators**)	2
	Public data communications network operators	11
	Commercial VSAT network operators	4
	Public radio paging service providers (**paging service providers**)	
	Public commercial satellite uplink/downlink gateway services (**gateway services**)	3
	Global mobile personal communications via satellite (GMPCS) (**gateway services operator)**	1
	Internet backbone and gateway services **(IB& GS)**	6
	Internet exchange point services **(IXP)**	2
	Non-facility based telecommunications service providers	
	Public Internet access services (ISP)	72
	GMPCS landing rights authorization	1
	Resale service providers (including XDSL & MVNO)	3
	National telecom access bureau service providers **(including Cybercafes, telephone bureaus, multi-purpose community telecentres (MCTs) etc.)**	
	Value added service providers	
	Premium rate service providers	16
	Audio-text service providers	1
	Store and forward service providers	1
	Electronic Data Interchange (EDI) service providers	0
	Credit card validation platform services providers	1
	Number portability platform services providers	0
	Call centre operators and service providers	1
	Other new types of value added service (VAS) providers	3
	Telecommunications dealers licenses	
	Telecommunications terminal equipment vendor's license (V)	0
	GMPCS terminal equipment vendor	0
	Radio-communication terminal equipment vendor's license (V) **X**	0
	Telecommunications terminal equipment installer's license (I)	16
	Telecommunications terminal equipment maintainer's license (M)	6

	Telecommunications internal wiring license (W)	19
	Telecommunications external wiring license (E)	3
	Technical personnel	
	Telecommunications terminal equipment individual installer's (I) license. (classes A, B, & C)	5
	Telecommunications terminal equipment individual maintainer's (M) license (classes A, B, & C)	2
	Telecommunications internal wiring (W) individual license	17
	Telecommunications individual's external (E) wiring license (class A)	4

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