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INVESTMENT POLICY REVIEW

KENYA



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PREFACE

The UNCTAD Investment Policy Reviews are intended to help countries improve their investment policies and to familiarize governments and the international private sector with an individual country's investment environment. The reviews are considered by the UNCTAD Commission on Investment, Technology and Related Financial Issues.

The Investment Policy Review of Kenya, initiated at the request of the Government, was carried out through a fact-finding mission in July 2004 and is based on information current at that date. The mission received the full cooperation of the relevant ministries and agencies, in particular the Investment Promotion Centre. The mission also had the benefit of the views of the private sector, foreign and domestic, civil society and the resident international community, particularly bilateral donors and development agencies. A preliminary version of this report was discussed with stakeholders at a national workshop in Nairobi on 22 March 2005. The report was also presented to Members of Parliament belonging to key committees at a workshop in Mombasa on 18 March 2005. Both workshops were organized jointly with the UNDP office in Kenya and with its financial support.

This report was prepared by Rory Allan, Shuvojit Banerjee, Quentin Dupriez and Raphaël Kaplinsky under the direction of Taffere Tesfachew and Khalil Hamdani.

It is hoped that the analysis and recommendations of this review will contribute to improved policies, promote dialogue among stakeholders and catalyse investment in Kenya.

Geneva, October 2005

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ABBREVIATIONS

ACP	Africa Caribbean Pacific
AGOA	African Growth and Opportunity Act
ARIPO	African Regional Industrial Property Organization
ATC	Agreement on Textiles and Clothing
B2B	business to business
B2C	business to consumer
BIT	bilateral investment treaty
BOO	build-operate-own
BOT	build-operate-transfer
CAA	Civil Aviation Authority
CCK	Communications Commission of Kenya
COMESA	Common Market for Eastern and Southern Africa
DTT	double taxation treaty
EAC	East African Community
EBA	Everything But Arms
EPZ	export processing zone
EPZA	Export Processing Zone Authority
ERSWEC	Economic Recovery Strategy for Wealth and Employment Creation
ERB	Electricity Regulatory Board
EU	European Union
FAA	Federal Aviation Authority
FDI	foreign direct investment
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GFCF	gross fixed capital formation
GJLOS	governance, justice, law and order sector
GSP	Generalized System of Preferences
HCDA	Horticulture Crops Development Agency
ICAO	International Civil Aviation Authority
ICSID	International Centre for Settlement of Investment Disputes
ICT	information and communication technology
IMF	International Monetary Fund
IPC	Investment Promotion Centre
IPO	initial public offering
IPP	independent power producer
JBIC	Japan Bank for International Cooperation
KACC	Kenya Anti-Corruption Commission
KARI	Kenya Agricultural Research Institute
KIA	Kenya Investment Authority
KIPI	Kenya Industrial Property Institute
KPA	Kenya Ports Authority
KPLC	Kenya Power and Lighting Company

KRA	Kenya Revenue Authority
LDC	Least Developed Country
M&A	merger and acquisition
MFA	Multifibre Arrangement
MFN	most favoured nation
MUB	manufacturing under bond
NARC	National Rainbow Coalition
NEMA	National Environment Management Authority
NIC	National Investment Council
NTR	normal trade relations
OECD	Organization for Economic Co-operation and Development
PPA	power purchase agreement
SADC	South African Development Community
SKN	seven key neighbours
SMEs	small and medium-sized enterprises
SNO	second national operator
SPS	sanitary and phytosanitary standards
STPP	Short-Term Priorities Programme
TNC	transnational corporation
TRIPS	Trade-Related Aspects of Intellectual Property Rights
UNCTAD	United Nations Conference on Trade and Development
UNESCO	United Nations Educational, Scientific and Cultural Organization
USITC	United States International Trade Commission
VAT	value added tax
WBES	World Business Environment Survey
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

KENYA



Key economic and social indicators

Indicator	1970	1980	1990	1995	2000	2001	2002	2003
Population (million)	11.5	16.6	23.4	26.7	30.1	30.7	31.3	31.9
GDP at market prices (billion dollars)	1.6	7.3	8.6	9.1	10.4	11.2	12.3	13.8
Real GDP growth (per cent)	-4.7	5.6	4.2	4.4	-0.2	1.1	1.0	1.3
Inflation (per cent)	2.2	13.9	17.8	1.6	10.0	5.7	2.0	9.8
GDP per capita (dollars)	139.5	436.8	365.4	339.0	347.2	370.8	393.0	432.6
GDP by sector (per cent):								
Agriculture	33.3	32.6	29.1	31.1	19.7	18.6	16.4	16.6
Industry	19.8	20.9	19.1	16.0	18.6	18.2	19.0	19.1
of which: Manufacturing	12.0	12.8	11.8	9.9	12.9	12.6	13.0	13.1
Services	46.9	46.6	51.7	52.9	61.7	63.1	64.6	64.2
FDI inflows (million dollars)	13.8	79.0	57.1	33.0	110.9	5.3	27.6	81.7
Exports of goods and services (per cent of GDP)	29.8	28.0	25.9	32.6	26.3	26.4	26.6	26.5
Imports of goods and services (per cent of GDP)	30.7	39.1	31.2	38.8	36.0	35.6	29.8	31.1
Gross capital formation (per cent of GDP)	24.4	24.5	19.7	17.5	15.4	14.7	13.6	15.6
Human development index rank	..	..	..	..	..	..	..	148
Adult illiteracy rate (per cent of people aged 15 and above)	59.4	43.9	29.2	23.0	17.6	16.7	15.8	..

Source: UNCTAD, FDI/TNC database (WIR04), World Bank (WDI 2004).

INTRODUCTION

Kenya has had a long history of economic leadership in East Africa as one of its largest and most advanced economies. However, inconsistent efforts at structural reforms and poor policies over the past couple of decades, have generated a prolonged period of decline in development indicators and significantly eroded the leadership position at a time when other countries in the region have made significant strides. While Kenya was a prime choice for foreign investors seeking to establish a presence in Eastern and Southern Africa in the 1960s and 1970s, poor economic policies and inconsistent efforts at structural reforms, growing problems of corruption and governance, and the deterioration of public services have discouraged FDI since the 1980s.

The democratic Government elected in late 2002 is well aware of the need to enact sweeping and lasting reforms of economic and social policy if it is to put Kenya on a sustained high-growth path. While it has started to enact some of the reforms underlined in its Economic Recovery Strategy for Wealth and Employment Creation adopted in 2003, much remains to be done. This report considers the improvements and reforms needed to allow private investment to blossom and be at the core of a marked acceleration in economic growth and wealth creation. It focuses in particular on the reforms required to attract significantly higher inflows of FDI and to enhance their contribution to economic development, and it proposes a strategy to achieve these goals.

Chapter I provides an overview of FDI trends and performance. Kenya has not been able to capitalize on its position of regional economic leadership to attract significant inflows of FDI. The poor growth performance, lack of consistent structural reforms and deteriorating infrastructure over the past couple of decades have actively discouraged FDI and led some large transnational corporations (TNCs) to reduce their operations in Kenya. By and large, Kenya has been left out of the global surge in FDI flows that started in the mid- and late 1990s and benefited its neighbours in the East African Community as well as much of Africa and the developing world. FDI has nevertheless been key to the success of a few dynamic sectors, including horticulture and the airline industry, highlighting the potential role that it could play in the country's development.

Chapter II examines the investment framework. Kenya's previously open regime to FDI was made sharply more restrictive at the very end of 2004, when the country imposed a minimum capital requirement for all foreign investors. However, amendments to the new law are currently being examined by parliament. If adopted, they would reinstate openness to FDI, as minimum capital requirements would be dropped altogether. The legal regime provides for a large degree of protection and non-discrimination against foreign investors, and the investment environment is mostly based on sound principles. Some of the key investment laws are outdated, however, and fail to account for modern practices and principles in conducting and regulating business. The system also leaves a large degree of discretionary power to the civil service in administering and enforcing the principles laid out in the laws. This negatively affects the predictability of decisions for investors and has been at the core of Kenya's governance problems.

Chapter III proposes a strategy for FDI attraction. It carefully considers Kenya's comparative advantages and weaknesses and identifies four pillars to serve as the foundation for a strategy to attract FDI. Pillar 1 is centred on the manufacturing of basic consumer goods and industrial inputs for the regional market, which has suffered from decline over the past decade, but which could be revived with targeted policies. Pillar 2 is centred on the development of Kenya as a regional services hub. Although it is already used to some extent as a regional platform for services providers, little or no specific policy attention has been given to build on Kenya's comparative advantage in the sector, and certain key impediments must be addressed. Pillar 3 is centred on the horticulture and floriculture sector, which has flourished in recent years with foreign investors' participation, but which could be further promoted and developed. An unconfirmed fourth pillar is centred on the promotion of FDI in export processing zones (EPZs). In particular, a strategy is needed to diversify away from FDI in garments, whose sustainability beyond 2005 and 2007, when heavily trade-distorting measures are to cease, is questionable.

Chapter IV highlights the main findings and recommendations of the Review.

I. FDI TRENDS AND PERFORMANCE

Kenya's economic leadership in East Africa has been undermined by two decades of poor economic policies, low domestic and foreign investment and slow growth. Expectations for the future are high, however, as it engages in a process of significant transformation. The elections in late 2002 brought in a new Government with a mandate to enact sweeping reform of economic and social policy. While a general agenda of economic reforms and a resurgence of economic growth would go some way towards reviving the interest of foreign investors, specific actions are necessary to turn Kenya into a more significant magnet for FDI than in the past and to ensure that the contribution of foreign investment for the very purposes of sustainable development and wealth creation is optimized.

A. Economic Backdrop

Kenya, once the top performer in East Africa, has experienced stagnation over the past two decades, even though it remains the second largest economy in the region after Sudan, and is one of the more developed ones. The rapid rise in agricultural output and the development of the industrial sector under high tariff protection generated strong growth in the 1960s and 1970s, making real GDP per capita in 1980 65 per cent higher than in 1964. The second oil crisis of 1979 found Kenya unprepared to respond to the shock, however, as the limitations on agricultural output growth and import substitution policies became obvious.

The 1980s and 1990s were characterized by a series of muted, incomplete and non-sustained attempts at macroeconomic and structural reforms. These never succeeded in putting Kenya on a sustained high-growth path, however, and only provided temporary relief based on the evolution of the world economic environment. The Government's attempts to control the fiscal deficit, although relatively successful, failed to address the issue of current expenditure and succeeded only through a drastic reduction in capital spending. This has been accompanied by the deterioration of the once reasonably efficient and well-developed public infrastructure and increasing problems of governance and insecurity, which further discouraged private investment. Despite some resurgence in growth in 1986-1989 and 1995-1996, real GDP per capita ended 5 per cent lower in 2003 than in 1980.

In spite of its poor performance over the past two decades, Kenya still benefits from a more diversified economy than most of its neighbours. Agriculture remains the single largest sector, accounting for 23 per cent of GDP in 2002. Some new sources of production have emerged strongly in recent years, however. Floriculture and horticulture have been some of the fastest growing areas and important sources of export earnings. The services sector also gained considerable importance after independence, with tourism as one of the main success stories, even though it has suffered in recent years from domestic insecurity and travel advisories in several Western countries. Manufacturing as a share of total production has fluctuated throughout the past couple of decades, but was about 13 per cent of GDP in 2002, similar to the level in the mid-1960s. The manufacturing sector has nevertheless been in difficulty in recent years as it has not been able to compete in global markets and has lost market shares in its traditional export markets within the region.

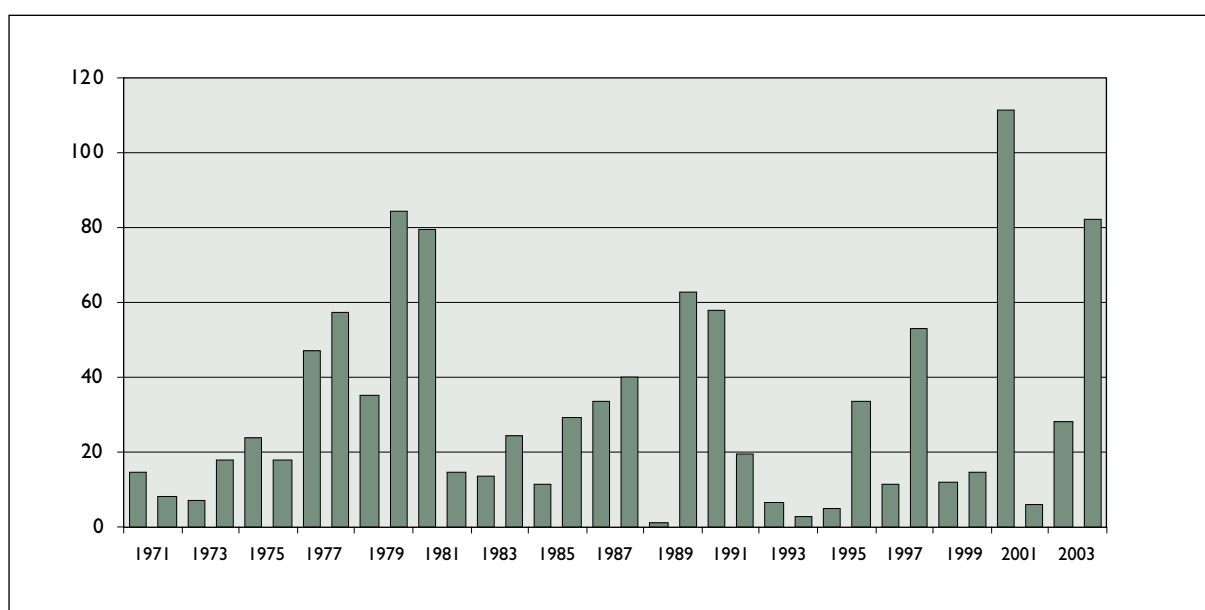
The new administration was thus handed the reins of a country in crisis following a long period of poor economic and industrial policies and where rampant corruption contributed to a weak investment climate (see figure III.1). The new administration is aware of the need to drastically improve policies and provide a favourable setting for private investment to generate wealth and reduce poverty. The Economic Recovery Strategy for Wealth and Employment Creation adopted in 2003 aims to ensure that the public sector plays its regulatory and facilitator role for private investment. The Strategy is articulated around seven key areas: (1) the macro-economic framework; (2) governance, security and the rule of law; (3) public sector reforms; (4) infrastructure; (5) sectoral policies in agriculture, tourism, trade and industry; (6) social policies; and (7) cross-cutting issues such as the financial sector, land or research and development policies. While foreign investors would benefit from improvements in all these areas, FDI could also contribute significantly in advancing the Government's objectives and setting Kenya on a higher growth path.

B. FDI Trends

I. FDI Size and Growth

FDI grew steadily through the 1970s as Kenya was a prime choice for foreign investors seeking to establish a presence in Eastern and Southern Africa. The relatively high level of development, good infrastructure, market size, growth and openness to FDI at a time when other countries in the region had relatively closed regimes all contributed to TNCs choosing Kenya as their regional hub. FDI started at a low of around \$10 million a year in the early 1970s before peaking at \$80 million in 1979-1980 (figure I.1).

Figure I.1 FDI Inflows to Kenya, 1970-2003
(Million dollars)



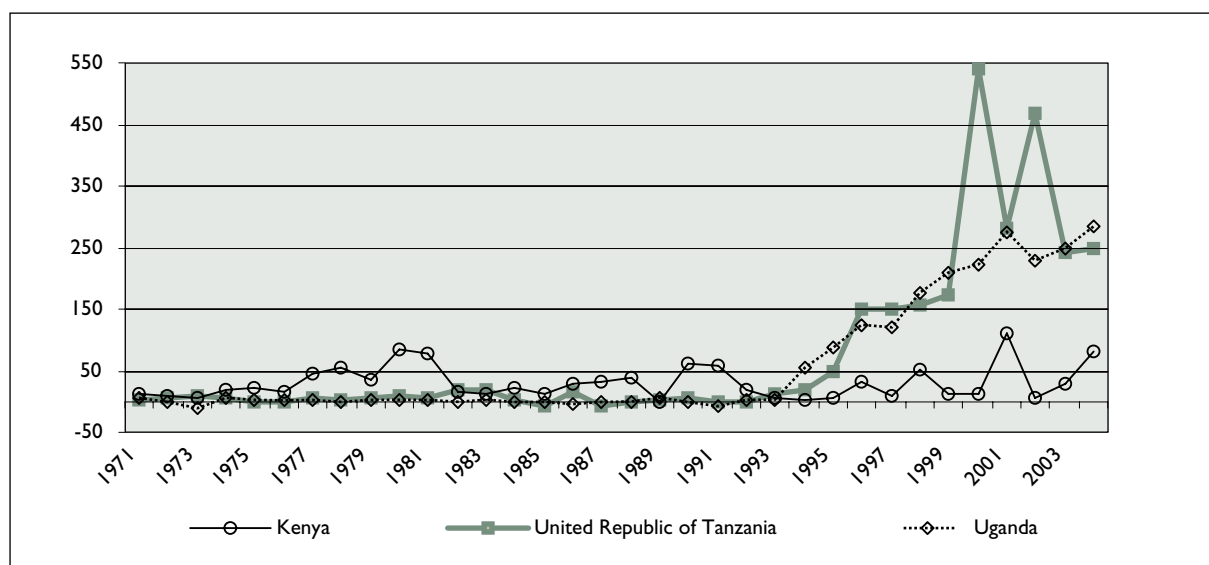
Source: UNCTAD FDI/TNC Database (WIR 2004).

The deterioration in economic performance highlighted above, together with growing problems of corruption and governance, inconsistency in economic policies and structural reforms, and the deterioration of public services and infrastructure, generated a long period of low FDI that started in the early 1980s and continues to date. Inflows of FDI in the period 1981-1999 averaged only \$22 million a year. Although the sale of mobile phone licences to Kenyan-foreign joint ventures pushed FDI to over \$100 million in 2000, inflows fell again to around their average of the 1980s and 1990s, before rising again in 2003 on the back of textile investments in export processing zones (EPZs) that may not prove sustainable.

Although Kenya was the lead destination of FDI to the East African Community (EAC) in the 1970s and 1980s, the relative level of inflows was never high by developing countries' standards, as illustrated by the stock of FDI, which was only 7.5 per cent of GDP in 2003, compared with 25.3 per cent for Africa as a whole and 31.5 per cent for developing countries (table I.1). Kenya's regional leadership in attracting FDI also disappeared as soon as the United Republic of Tanzania and Uganda started reforming their economies and opening up to foreign investors in the early 1990s, at a time when Kenya itself was suffering from economic stagnation. The end of apartheid in South Africa in 1994 also increased competition in the attraction of large TNCs seeking a single production or headquarters centre in English-speaking Africa.

FDI inflows in 1996-2003 averaged \$39 million a year, while inflows to the United Republic of Tanzania and Uganda surged to \$280 million and \$220 million, respectively, from negligible levels in the 1980s (figure 1.2). In relative terms, Kenya fares even worse, as its economy was about 30 per cent larger than the United Republic of Tanzania's and twice as big as Uganda's in 2002. While developing countries as a whole attracted an annual average of \$41 of FDI per capita in 1996-2003, Kenya only drew average inflows of \$1.3 per capita. This ranks Kenya as 129th (out of 140 countries) on UNCTAD's FDI performance index in 2001-03.¹ It has also never ranked better than 111th at any time since 1990.

Figure 1.2 FDI Inflows to Kenya, the United Republic of Tanzania and Uganda, 1970-2003
(Million dollars)



Source: UNCTAD FDI/TNC Database (WIR 2004).

Kenya has thus missed out on the global surge in FDI that affected most of the world in the 1990s. While its average annual level of FDI inflows doubled between 1981-1985 and 1996-2003, the average inflow into African countries was multiplied by six, and average inflows into developing countries as a whole almost increased tenfold. The factors behind Kenya's poor performance in attracting FDI at a time of a global surge in flows, including to its most immediate neighbours with similar economic structures, must thus be found mainly within the country. The lack of significant progress and the stop-go nature of economic reforms over the past decades, the prevalence of corruption, the mediocre growth performance, the deterioration in the quality of infrastructure and the rising cost of services are all major factors that hampered FDI.

The absence of a large-scale privatization programme designed to attract large foreign investments and Kenya's limited mineral resources also deprived it of a traditional magnet of FDI in Africa. The last major privatization operation involving foreigners was the sale of a stake of Kenya Airways to KLM of the Netherlands in 1996. Very little investment has taken place in mining, not only because of limitations in terms of resources, but also as a result of an obsolete mining code.

The deterioration in Kenya's infrastructure services and rising costs, particularly at a time of major improvements in infrastructure in other parts of the developing world, have also induced many foreign investors already established in the manufacturing sector to divest or consolidate their operations out of Kenya in

¹ The performance index is calculated as the ratio of a country's share in global FDI inflows to its share in global GDP.

Table I.1 Comparative Performance of Kenya with Selected Countries, 1981-2003
(Dollars and percentage)

Country	ABSOLUTE PERFORMANCE										RELATIVE PERFORMANCE									
	FDI inflows per year					FDI Stock	Per capita (dollars)					FDI inflows					FDI Stock	Per capita (dollars)		
	Million dollars					Million dollars	Per \$1000 GDP (dollars)					As percentage of GFCF					Per capita (dollars)			
	1981-1985	1986-1990	1991-1995	1996-2000	1996-2003	2003	1981-1985	1986-1990	1991-1995	1996-2003	1981-1985	1986-1990	1991-1995	1996-2003	1981-1985	1986-1990	1991-1995	1996-2003	2003	
Kenya	18.1	38.4	12.8	39.8	39.2	1 045.9	1.0	1.7	0.5	1.3	2.9	4.7	1.5	3.4	1.6	2.4	0.8	2.4	31.7	7.5
Botswana	49.8	72.4	-48.2	72.3	110.4	1 080.1	50.1	62.2	-36.1	71.9	41.8	31.1	-11.9	20.7	16.9	15.5	-4.5	9.1	540.0	14.6
Lesotho	3.9	11.7	19.2	30.1	31.0	427.1	2.7	7.1	10.6	15.4	10.4	22.7	22.8	34.5	2.9	4.9	3.9	7.5	213.5	38.0
Mozambique	0.4	5.0	32.0	178.5	205.0	1 841.6	0.0	0.4	2.1	11.2	0.1	2.1	14.9	53.8	0.1	0.7	7.2	24.3	96.9	42.6
Namibia	3.3	7.3	109.0	99.2	140.7	1 175.5	2.9	5.5	72.4	80.3	2.2	3.2	35.4	43.8	1.9	2.0	18.9	20.0	587.8	39.1
South Africa	87.5	-72.7	376.5	1 517.3	1 986.8	30 373.1	2.9	-2.1	9.5	46.3	0.7	-0.8	2.6	15.6	0.2	-0.4	1.7	10.3	675.0	18.5
Uganda	-0.4	-0.6	54.2	200.9	220.7	2 042.2	-0.1	-0.1	2.8	9.5	-0.1	-0.2	12.5	36.8	-0.1	-0.1	7.0	19.1	78.5	32.9
United Republic of Tanzania	8.8	0.3	46.4	260.4	282.2	2 582.5	0.4	0.0	1.5	8.1	1.4	0.1	9.0	32.4	0.6	0.1	4.4	19.9	68.0	26.8
Zambia	19.0	112.5	53.7	161.4	132.6	2 341.4	2.8	14.5	6.1	13.1	7.5	35.5	16.0	38.1	6.6	37.4	10.3	19.8	212.9	55.2
COMESA	894.2	1 401.4	1 542.6	3 393.3	3 656.3	51 900.3	4.2	5.6	5.2	10.4	10.2	12.4	13.6	21.7	4.3	4.3	7.7	12.1	136.7	29.4
Africa	1 879.3	2,850.4	4 497.9	9 136.2	11 513.8	167 111.3	3.8	4.9	6.7	14.5	5.2	6.8	9.6	20.2	2.1	2.8	5.3	11.4	196.5	25.3
Africa excl. South Africa	1 791.8	2,923.2	4 121.4	7 618.9	9 526.9	136 738.3	3.9	5.4	6.6	12.9	6.3	9.0	12.5	21.7	2.5	3.8	6.5	11.9	169.8	27.6
Developing countries	20 537.3	27 870.2	80 793.7	205 856.8	197 331.1	2 280 171.3	6.0	7.2	18.5	40.9	8.2	9.0	16.5	30.7	3.3	3.3	6.0	12.0	449.7	31.4

Source: UNCTAD FDI/TNC Database (WIR 2004).

recent years. Although this has taken place partly as a consequence of worldwide strategies of consolidation of production centres by manufacturing groups such as Procter and Gamble (which moved its detergent production line to Egypt in 1999), Johnson and Johnson (which moved production to Zimbabwe in 2000) or Colgate Palmolive (which has been gradually phasing out production in Kenya while preserving support services for the region in Nairobi), Kenya has in general been on the “moving out” side of the equation rather than the “moving in” side as a result of its relatively high operation costs.

Although it would not change the overall assessment of underperformance in FDI attraction, poor data collection is likely to somewhat underestimate actual inflows of FDI. There is no clear mandate by any agency to collect data on FDI and the Central Bank of Kenya, the Investment Promotion Centre and the Central Bureau of Statistics all collect only partial information on either balance-of-payments flows or investment projects. Data collection was also made more complicated after the full liberalization of the exchange rate regime in 1994.

Circumstantial evidence and the mere presence of a large number of major and minor TNCs in Nairobi and other big cities indicate that the impact and prevalence of foreign investment in Kenya may be larger than what is captured by official statistics. The nature of FDI in Kenya appears to be quite dispersed among a large number of smaller projects. However, the fact remains that the level of FDI has been low and stagnant over the past couple of decades, and well below Kenya’s potential. There has also been a worrying trend of foreign investors moving out and consolidating out of Kenya, with few new investors coming in or existing investors planning significant expansion.

2. Distribution by Sector and Industry

The most notable recent trends in the sectoral composition of FDI are investments in the horticulture, floriculture and garments areas, in addition to continued investment in tourism. Interest in horticulture and floriculture has been in response to favourable local conditions linked to climate and transport infrastructure. Garment investment has been in response to the United States granting preferential access to its market under the African Growth and Opportunity Act (AGOA). There is a strong possibility, however, that Kenya will not continue to attract such investments in the future following the full elimination of quotas in 2005 with the integration of textile trade under normal WTO rules (see chapter III).

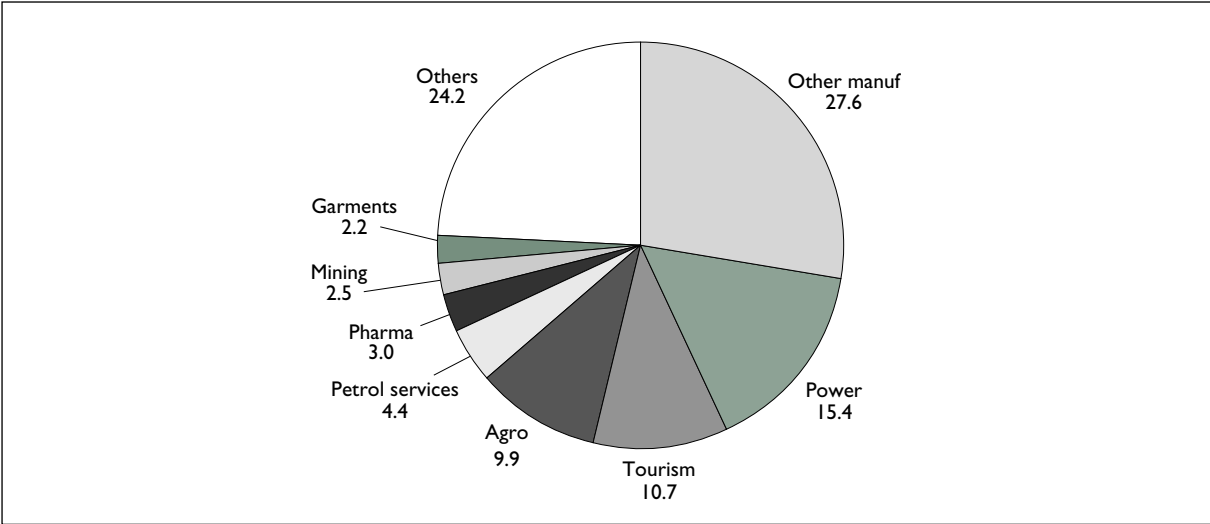
Kenya does not keep comprehensive data on the value of actual foreign direct investment by sector and industry. The sectoral breakdown of the 820 projects with a foreign participation that the Investment Promotion Centre (IPC) registered between 1997 and 2004 is provided in figure I.3. The list is not indicative of all foreign investment in the country as investors are not required to liaise with the IPC and not all projects are implemented. Foreign participation in the economy has been diversified, with “other manufacturing” and “other sectors” accounting for half of the foreign investment recorded by the IPC. Other manufacturing consists of a wide variety of basic consumer and industrial goods. Other sectors include services such as transportation and construction, assembly and trading. The largest sectors of note are investments in power generation, tourism, agriculture and agroprocessing.

Foreign investors play a major role in floriculture and horticulture, with close to 90 per cent of flower production controlled by foreign affiliates.² Foreign investors have also been in good part responsible for the success of the sector. A Dutch company, Dansk Chrysanthemum and Kultuur (DCK), the then largest world producer of chrysanthemum cuttings, was the first to set up a large flower firm in 1969, with the benefit of government incentives and a Dutch government grant.³ Many of its employees subsequently went on to play a role in other flower and vegetable companies. Brooke Bond of the United Kingdom also invested in a former

² UNCTAD (2002, p.155).

³ World Bank (2003a).

Figure 1.3 Sectoral Breakdown of FDI Projects Registered by IPC, 1997-2004
(Percentage of foreign capital value)



Source: Investment Promotion Centre.

DCK farm that became a major flower and vegetable firm. It was taken over by Homegrown in 2002 and renamed Kingfisher Farm. In the 1980s, Dutch investors formed the Oserian Development Company, which is now a leading horticulture player with 4,500 workers.

The initial development and growth in horticulture were favoured by spillovers from the tourism sector. Frequent passenger air connections with Europe provided the essential cargo space for transporting fresh produce from Kenya at a time when volumes would not justify the use of dedicated cargo planes. Rapidly growing export volumes subsequently made the use and development of cargo facilities economical, but the initial spillover from tourism was essential. The growing use of high-quality fruit and vegetables by local hotels and restaurants also gave farmers more experience in horticulture and an outlet for produce not meeting export standards.

Kenya’s success in growing vegetables is also related to the growth of the Asian community in the United Kingdom and the expertise and knowledge brought by Asians who were expelled from Uganda and had good knowledge of and close links with Kenya. This increased the demand for Asian vegetables, for which Kenya has an advantage in production as they can be grown throughout the year. The presence of the Asian community in Kenya means that there are many family ties with traders in London, reducing transaction costs. The involvement of smallholders has also been important in the growth of the sectors. They entered production because of low prices for coffee and tea in the 1970s. Most exporters have contracts with large UK and European retailers. They have processing factories near Nairobi airport where vegetables grown in rural areas are prepared for delivery. In the early 1990s smallholders represented the majority of vegetable production for export, although by the end of the decade they had been superseded by large commercial farms and exporters’ own farms.⁴

Manufacturing FDI has concentrated on consumer goods sectors, such as the food and beverage industry. This has changed in recent years, however, with the growth of the garments sector because of AGOA. Of 34 companies producing garments for the US market, 28 are fully foreign-owned.⁵ AGOA-related investments in the past couple of years have represented around 80 per cent of FDI. Though these investments have increased

⁴ McCulloch and Ota (2002).

⁵ Export Processing Zone Authority.

employment and exports, the dominance of garments-related FDI is of concern as it may not be sustainable. Foreign enterprises have entered to take advantage of the duty- and quota-free access to the United States which is available. With the elimination of remaining quotas in 2005 and the integration of trade in textiles and clothing under normal WTO rules, it is likely that China and other Asian countries will supply a large part of the US apparel market owing to their cost and quality advantage over many countries, including Kenya⁶ (see chapter III).

FDI in services has been directed to a wide array of sub-sectors, including tourism, financial and business services and telecommunications. The country's diversified tourism sector has long been a magnet for foreign investment. Tour operators are dominated by foreign operators such as United Touring Company (UK), Express Travel (US), Abercrombie and Kent (UK) and Pollmans (Germany). The largest projects are in the establishment of hotels and lodges for coastal and safari tourism. A number of the major international hotel chains are present, including Hilton, Intercontinental, Serena, Block Hotels and Holiday Inn. New trends have been timeshare holidays and ecotourism.

Kenya has also attracted foreign investors in banking and professional services. Companies such as Deloitte Touche Tohmatsu, Ernst and Young and KPMG base their main East African operations in Kenya. Thirteen of the 43 banks in Kenya are foreign, controlling 51 per cent of total banking assets in the country. The largest are Barclays (UK, 21 per cent of assets), Standard Chartered (UK, 14 per cent), Citibank (US, 7 per cent), and Stanbic (South Africa, 2 per cent). Two of these international banks (Barclays and Standard Chartered) dominate commercial banking along with the State-controlled Kenya Commercial Bank.

The power sector has seen investment through the award of Independent Power Producer (IPP) contracts to foreign investors: IberAfrica Power (Spain), Westmont Power (US), OrPower4 (US), and Tsavo Power (a consortium). Four of the 14 IPPs in Africa are based in Kenya.

Foreign investors have been involved in the telecommunication sector through their shareholding in the two mobile phone operators and the purchase of licences in 1999 and 2000. Safaricom is 40 per cent owned by Vodafone of the United Kingdom and Kencel is currently 60 per cent owned by Celtel of the Netherlands (which purchased Vivendi's participation in 2004). Both consortiums purchased licences through auctions for \$55 million each. A third national mobile operator, Econet of South Africa, was awarded a licence in 2003, but has not been able to operate due initially to litigation by the other bidders and subsequently to internal disagreements within the consortium. The end of Telkom Kenya's monopoly on voice telephony and internet backbone provision in July 2004 has opened the way for new entrants in the sector. Safaricom, among others, has bid for an internet gateway licence. A second fixed line operator was selected in July 2004 through competitive bidding, but the process has been subsequently put on hold due to a dispute between the regulator and the Government regarding the bid price.

There have been a number of initiatives targeted at investment for export purposes, mainly by foreign enterprises. The Government introduced a manufacturing under bond (MUB) scheme in 1987, and created EPZs in 1990. These schemes attracted little foreign investment until the accession of Kenya to AGOA in 2001, however.

Most foreign investment in manufacturing since 2001 has been in the EPZs, with the majority (60 per cent of total EPZ investment by 2003) in AGOA-related textiles. There were 55 foreign or joint-venture enterprises (as well as 11 fully local companies) operating in EPZs in 2003.⁷ EPZs have expanded from their initial textiles focus to also produce a number of other goods, although the domination of garments remains strong (table 1.2). The largest single investment is the De La Rue currency printing operation with a value of \$48 million.

⁶ U.S. International Trade Commission (2004a).

⁷ Export Processing Zone Authority.

Table I.2 FDI in EPZs, 1990-2003
(Million dollars)

Sector	Number of firms	Total investment
Garments	30	111.0
Currency & security documents	1	47.7
Spinning	1	5.3
Chemicals	4	4.0
Pharmaceuticals	3	2.4
Service	8	1.3
Agro processing	2	1.0
Electronics	2	1.0
Others	4	2.5
Total	55	176.0

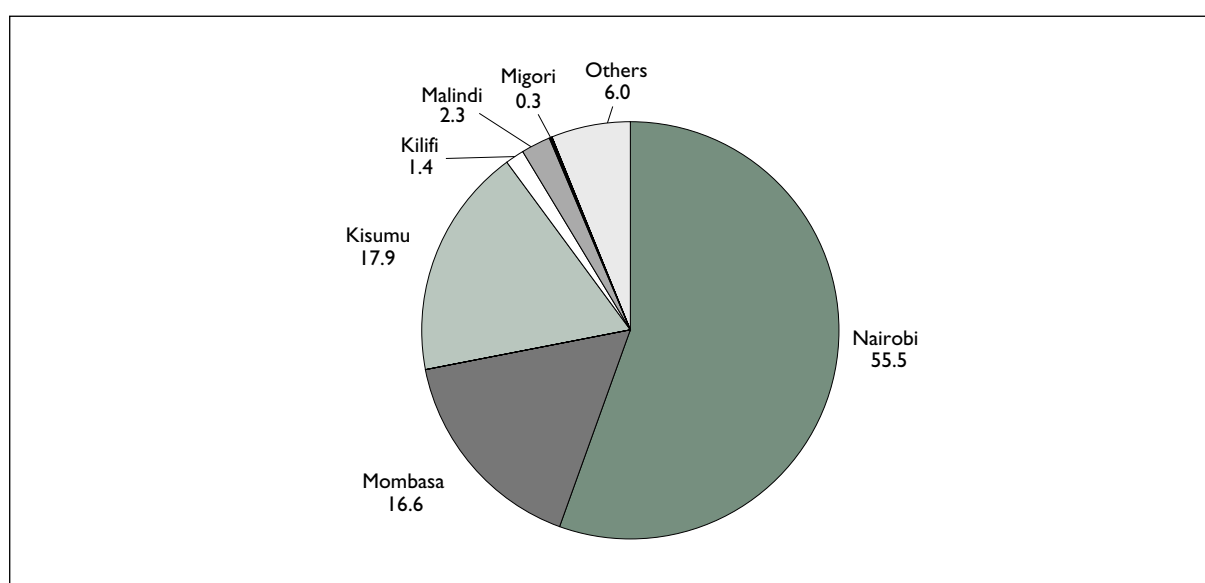
Source: Export Processing Zone Authority.

3. Distribution by Region

No comprehensive data on the regional distribution of FDI are available. The information collected by the IPC on registered investment projects has significant weaknesses as it fails to capture non-registered investments, and is based on investment proposals instead of actual disbursements. In spite of these caveats, the IPC data provide useful indications about the regional distribution of FDI.

Not surprisingly, FDI projects tend to be concentrated in the Nairobi and Mombasa areas, which accounted for 56 per cent and 17 per cent of the value of IPC-registered projects in 2000-2004⁸ (figure I.4). The concentration is higher still for manufacturing and services FDI, with Nairobi attracting close to 70 per cent of foreign investments in the services sector, and Mombasa another 23 per cent.

Figure I.4 Regional Distribution of FDI-Registered Projects, 2000-2004
(Percentage of total)



Source: Investment Promotion Centre.

⁸ Nairobi and Mombasa accounted for 78 per cent and 11 per cent of the number of registered projects in the same period.

Foreign investments in agri-business, in contrast, are mostly located outside the Nairobi and Mombasa areas. Most of the highly successful and labour-intensive horticulture and floriculture farms are located in the foothills of Mount Kenya and around Lake Naivasha. Dominion Farms invested about \$4 million in a modern farm in the Kisumu area (Lake Victoria) to produce, among others, maize, rice and cotton. Similarly, foreign investments in tourism have been more evenly spread across the country. Many of these investments in horticulture, floriculture and hotels were not captured in the IPC data, however. The actual concentration of FDI in the Nairobi and Mombasa areas is thus likely to be less pronounced than is indicated by the data. The impact of these foreign investments in terms of employment is also likely to be more evenly spread across the country, given the labour-intensive nature of agri-business and tourism.

4. Types of FDI

The form of entry of FDI has been primarily through the establishment of greenfield operations. The Government's privatization drive in the 1990s led to the sale of 207 enterprises, although with the exception of Kenya Airways these were small and medium-size companies, and around 97 per cent of buyers were Kenyans.⁹ The largest sale to date has been the acquisition of 26 per cent of Kenya Airways by KLM in 1996 (box I.1).

The Government is currently planning a second wave of privatizations, with 33 companies earmarked for full or partial sale. The new list includes a number of big-ticket items, including the National Bank of Kenya, Kenya Commercial Bank, Kenya Power and Lighting Company, KenGen, Kenya Petroleum Refineries, Kenya Ports Authority, Telkom Kenya and Kenya Railways Corporation. The methods of sale are expected to range from concessioning to sale on the Nairobi Stock Exchange or securing a strategic partnership with a major player in the relevant sector.

Box I.1 Kenya Airways: Efficiency Through Strategic Foreign Investment

Kenya Airways was privatized in 1996 through a carefully managed process culminating in the sale of part of the company. A new board came in at a desperate time for the airline in 1991 and decided on a process of commercialization. It appointed a management team drawn from international consultants that redefined the company objectives, streamlined the organization chart and created a culture of profit-making. Kenya Airways announced its first profit in the fiscal year 1993-1994. In 1994, the International Finance Corporation (IFC) was appointed to provide assistance with the company's privatization.

The Government received \$76 million from the sale of 77 per cent of the shares in 1996 via a series of competitive bidding auctions. Strategic investor KLM Royal Dutch Airlines acquired a 26 per cent interest, with local investors remaining in control.

Privatization has drastically improved the reliability and performance of the national carrier, which an industry journal named "African Airline of the year" in June 1999. It is one of the few profitable airlines in Africa and one of the market leaders in flights between Europe and Africa and within Africa. In 2003, it tripled its net profit to \$16 million with passenger revenues of \$322 million. The company is generally seen as operating at standards of major international airlines worldwide.

Privatization has led to a major increase in routes served. Some 30 per cent of revenue now comes from a greatly increased domestic service, including 60 weekly Nairobi–Mombasa flights and others to secondary Kenyan cities not previously served. The airline has also added frequent flights in and out of Cameroon, Malawi, Nigeria, Uganda, Zambia and other countries using Nairobi as a hub.

Source: Kenya Airways website and IFC (2004) "A New Look at African Privatization".

⁹ OECD (2003).

5. Countries of Origin

More than 200 TNCs operate in Kenya. The main traditional sources of investment are the United Kingdom, Germany and the United States. The British are the largest group, with the most long-standing investors, including Barclays, Standard Chartered, BAT, and CDC Capital Partners (table I.3). However there have only

Table I.3 Selected TNCs' Affiliates in Kenya, 2002
(Number and millions of dollars)

Company	Home econ	Industry	Sales (\$ mn)	Employees
A. Industrial				
British American Tobacco (Kenya)	UK	Tobacco	151	780
East African Industries	UK	Pharma	141	1 920
Unilever Kenya	UK	Food	117	1 400
Colgate Palmolive	US	Consumer goods	..	..
Procter & Gamble	US	Consumer goods	..	..
DeLarue	UK	Printing	..	..
Homegrown	UK	Agric	..	..
Tetrapak	Sweden	Packaging	..	..
Coca Cola	US	Beverages	..	..
Brooke Bond Kenya	UK	Agric	43	19 767
East African Portland Cement Company	France	Non-metal min.	33	515
Carnaud Metalbox	US	Metals	23	300
The Standard	UK	Printing	15	323
George Williamson Kenya	UK	Agriculture	14	4 813
Rhone Poulenc Kenya	France	Pharmaceuticals	13	128
Cadbury Kenya	Netherlands	Food	12	230
Nestle Foods Kenya	Switzerland	Food	11	116
B. Tertiary				
Basf East Africa	Germany	Trade	..	400
Total Kenya	France	Trade	202	320
Express Kenya	Switzerland	Transport	44	345
Deloitte Touche Tohmatsu	US	Consulting, tax	..	..
KPMG	US	Consulting, tax	..	..
Ayton Young Rubicam	UK	Advertising	..	..
Amiran Kenya	UK	Trade	30	102
Tibbett & Britten Kenya	UK	Transport	21	530
Cetco	Germany	Trade	13	25
Hoescht East Africa	France	Trade	7	300
Express Mombasa	Switzerland	Transport	..	9 280
Securicor (Kenya)	UK	Other bus. serv.	..	5 200
Interfreight (Kenya)	Switzerland	Transport	..	400
Jos Hansen & Soehne (East Africa)	Germany	Trade	..	210
C. Finance and Insurance				
Barclays Bank of Kenya Ltd	UK	Finance	937	2 024
Citibank	US	Finance	..	..
Stanbic Bank Kenya Ltd	South Africa	Finance	84	125
Standard Chartered Bank (Kenya)	UK	Finance	..	1 130
American Life Insurance Company (Kenya)	US	Insurance	..	209
Phoenix East Africa Assurance Co	United Rep. Tanz.	Insurance	..	90
Old Mutual	South Africa	Insurance	..	..
Independent Adjusters Kenya	Netherlands	Insurance	..	6
Insurance Holdings (Africa)	US	Finance	..	3

Source: UNCTAD FDI/TNC database.

been two large recent British investments, Vodafone and De La Rue. The market value of US investment is estimated at around \$285 million, primarily in commerce, light manufacturing and the tourism industry.¹⁰ Major US investors are General Motors, Eveready Batteries, Colgate Palmolive, Sara Lee, and Wrigley.

South Africa is a growing source of investment in diverse sectors. Major investors are mainly in services – Stanbic in banking, Shoprite and Metro Cash and Carry in retail, Protea Hotels, Nandos and Steers in restaurants, and Engen in petroleum products. Participation from Far Eastern countries, including China and Japan, though small in total, is rising. Chinese companies are active in construction, tourism and some manufacturing assembly. Investment in EPZs has been dominated by foreign investors. They account for the majority of operating enterprises with 71 per cent of the total in 2003, while joint ventures between Kenyans and foreigners accounted for another 16 per cent.¹¹ FDI in the EPZs is primarily from Asian countries (table I.4), although the United Kingdom has a particularly large representation due to the De La Rue security printing operation. Most of the Asian investors are active in the garments sector and have established operations in Kenya in order to benefit from fiscal incentives (see chapter II), but mostly to take advantage of the quota-hopping opportunity to access the US market.

Table I.4 Country of Origin of EPZ Investors and Total Investment, 2003
(Number and million dollars)

Country/economy of origin	Number of firms	Total investment (million dollars)
China/Hong Kong (China)	7	11.1
India	10	27.4
Sri Lanka	8	148.7
United Kingdom	6	56.1
Joint Venture	12	30.5
Kenya	9	2511.0
Others	14	54.6
Total	66	219.6

Source: Export Processing Zone Authority.

C. Impact of FDI

Although the level of FDI has been low both in absolute and in relative terms over the past decades, its impact on the economy should not be underestimated. Foreign investors in Kenya have indeed tended to make relatively small investments, but they are numerous and established across a wide variety of sectors. Foreign investors have also contributed significantly to some of the more dynamic sectors in the economy, including horticulture, and to export diversification. As was mentioned previously as well, significant weaknesses in data collection are likely to underestimate the actual flows of FDI.

I. Capital and Investment

Private and public domestic investment have suffered in the past decades from a combination of poor investment climate, high external indebtedness, low domestic savings and the need for fiscal consolidation. These factors and policies have generated a sharp contraction in public investment in infrastructure and social services, reduced the availability of funds for private investment and increased their cost. Gross domestic investment was 13.1 per cent of GDP in 2002, with gross domestic savings at 10.4 per cent of GDP. Persistent government budget deficits have also contributed to the scarcity and high cost of funds for domestic private investors. In such a context, FDI could play a significant role in providing extra sources of capital and investment and help close the

¹⁰ U.S. Department of Commerce (2004).

¹¹ Economic Survey 2004.

savings gap. In the period 1996-2003, however, FDI inflows represented only 2.4 per cent of gross fixed capital formation (GFCF), compared with 11.4 per cent for Africa and 12 per cent for developing countries as a whole.

While the numbers may be somewhat underestimated, Kenya certainly lags far behind in terms of FDI contribution to GFCF compared with other developing countries. Part of the reason is the slow progress in opening up the infrastructure sector to private investment. Some of the major contributions of FDI to capital and investment have nevertheless occurred in the telecommunications sector, where the auction of two mobile phone licences in 1999 and 2000 led to the rapid build-up of infrastructure, in part financed by foreign investors. The auctions and competition introduced in mobile telephony generated a sharp increase in the availability and quality of telecommunication services, with the number of users reaching 3 million in 2003 (out of a population of 32 million people) and mobile phone subscriptions outnumbering fixed line connections by 6 to 1.

The opening of the power generation sector to private investment in the late 1990s also allowed the rapid increase in power supply that was needed at the time through the involvement of foreign IPPs. The four IPPs currently account for about 20 per cent of total capacity. The pressing need to increase capacity in the late 1990s and the uncertain economic and regulatory environment at the time, however, forced the Government to accept expensive bids from private investors. So far, the private sector has not been allowed to play a significant role in other infrastructure sectors such as ports, airports, roads, railways, water or electricity distribution. The Government nevertheless plans greater private sector involvement in these sectors in the future, as part of its renewed privatization drive.

2. Technology and Skills

Technological transfers have taken place mostly through transfers of managerial skills and processes, and not so much through embodied technology. Formal research and development is very low and is confined to a few large enterprises. The operations of foreign enterprises in manufacturing are largely in the production of low-end consumer and agroprocessed goods for the local and regional market and cut-make-trim operations in garments for the United States. There are a few cases of more complex technology use or use of advanced processes in manufacturing, as with General Motors in vehicles, and Tetrapak in packaging. In the former case, although the technology used is of an older vintage compared with operations in many other regions, efforts have been made to constantly upgrade automation in order to improve productivity. Tetrapak has applied World Class Manufacturing techniques to its Kenyan operations since 2001 as part of a global programme.

FDI has played an important role in introducing technology and knowledge in horticulture and floriculture. This has enabled the sector to become a leading exporter of high-value products to the European market. Farms have invested the large amounts of capital required, estimated at \$50,000 per hectare, to set up world-class facilities. Basic costs entail land preparation, setting up irrigation systems, greenhouses, refrigerated storage and staff welfare facilities. Processes are becoming increasingly sophisticated. Steel or aluminium greenhouse structures are rapidly replacing wood, and growers are paying more attention to the use and quality of inputs. For example, Dutch-owned Oserian has installed one of the world's biggest geothermal heated greenhouses in order to reduce disease pressure and increase rose yield through more uniform temperatures. Communications technology is being improved by companies to ensure that produce can efficiently reach customers in Europe within 24 hours. Homegrown, the largest producer of flowers and vegetables, has recently introduced wireless data communication linking their production, cooling and packing facilities in Kenya with order information from their customers in Europe.

There has been little resort to foreign technology contracts, with local firms in general purchasing technology embodied in used equipment.¹² An exception is the local firm HACO Industries, which has extensive licensing relationships with foreign enterprises, resulting in considerable technology transfer (box I.2).

¹² UNCTAD (2003).

FDI has been at the root of transfers of skills to local workers. This has been possible due to the good trainability of employees, given the relatively high level of general education. The Government imposes an understudy programme for each expatriate employee recruited by foreign investors, with the aim of replacing the expatriate with a Kenyan employee in the medium term. Foreign firms have often gone beyond the legal requirements and provided training to their employees on a wider basis. Many give a high level of responsibility to local staff by providing ongoing training programmes in order to allow them to occupy top management positions. Multinationals in the country are characterized as having only a few posts, often managing director and finance director, occupied by expatriates. Colgate-Palmolive, for instance, sends staff for training to offices abroad where the “Colgate Curriculum” is taught. Some of such staff have in turn become “Master Instructors” for Colgate worldwide.

Box 1.2 HACO Industries: Using Licensing to Access Foreign Technology

HACO Industries is a long-established local firm, having set up in 1974. It started off as the local producer of BIC pens. It then proceeded to expand, with the company’s overall strategy being the use of key alliances. In the 1990s it diversified through the acquisition of licences from a number of foreign cosmetics companies, including Alberto-Culver and E.T. Browne. The company further expanded operations after obtaining licences for household cleaning products, most notably Jeyes of the United Kingdom.

Manufacturing licences and confidentiality agreements formed the basis for transfers of technology and know-how. Benchmarks and tools have been developed jointly, with practices adapted to local conditions. “Soft” knowledge transfer has included improvements in business evaluation and marketing processes.

Source: investor interview.

Local skill levels are sufficiently well regarded for there to be an increasing trend for Kenya to be the regional headquarters or services hub of multinationals. Headquarters functions are sometimes maintained in Kenya for East African operations even when production lines are moved elsewhere. These include such operations as accounting and strategic planning. This is the case with the East African operations of Colgate-Palmolive, Old Mutual and Deloitte. Old Mutual, for example, will be managing some back-office operations for the United Republic of Tanzania and Uganda from Nairobi, to result in a planned doubling of staff. Executives from Kenyan operations are also sent abroad to staff offices in the region owing to the lack of candidates of equivalent calibre available there, as is the case with Deloitte. One is thus witnessing in some cases a movement of manufacturing away to the region in tandem with retention, and in some cases expansion, of headquarters services functions in Kenya.

The presence of foreign banks has had a positive effect on the local banking sector. Foreign banks as a group display greater efficiency than their national competitors. They have higher levels of assets, loans and deposits per employee than both State-owned banks and private domestic banks.¹³ Foreign banks also have lower interest rate spreads than State-owned banks. Since these two groups constitute the only large banking institutions in the country, foreign banks have been important in lowering the financing costs faced by local corporate and retail borrowers.

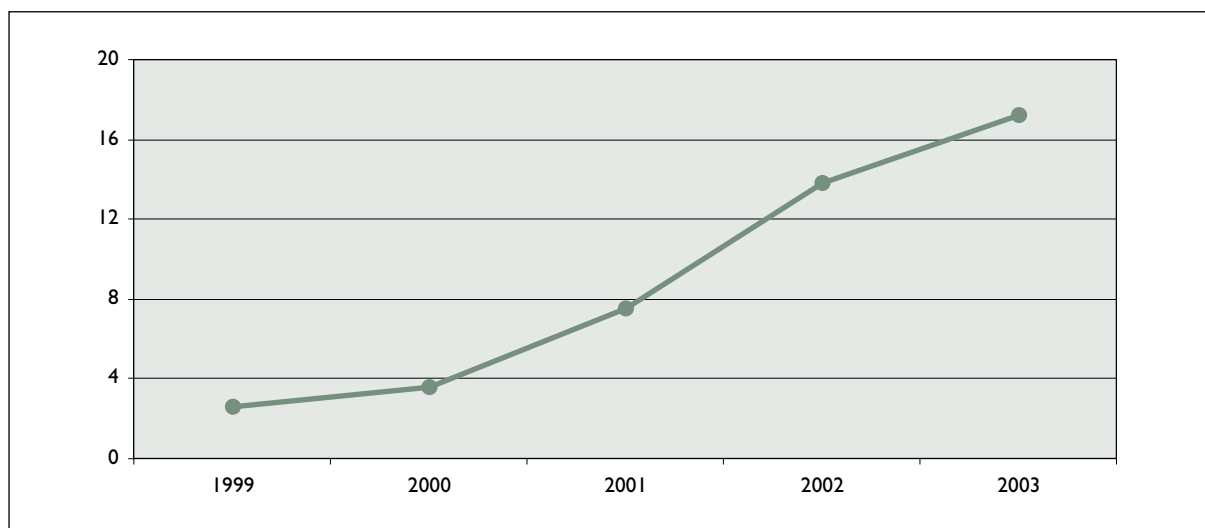
3. Employment and Linkages

FDI has been an important source of employment in recent years. The rise in foreign investment in labour-intensive garment production boosted employment in EPZs to 35,000 people, with around 12,000 additional

¹³ World Bank (2004a).

jobs created indirectly as a result of sub-contracting. EPZ employment, which rose 32 per cent in 2003 from a year earlier, accounted for around 17 per cent of total formal manufacturing employment in 2003, up from less than 3 per cent in 1999 (figure I.5).

Figure I.5
EPZ Employment as a Proportion of Private Formal Sector Manufacturing Employment, 1999-2003
(Percentage)



Source: Economic Survey 2004.

The other sector where foreign investors have significantly contributed to output and employment growth is horticulture, which is also labour-intensive. There were about 135,000 people employed in the sector as of 2003,¹⁴ compared with a total of 260,000 formal private sector agriculture and fishery workers.¹⁵ These positive developments have been offset somewhat by the loss of employment in traditional sectors of foreign investment in the manufacture of consumer and other goods. Manufacturing employment suffered a net decline between 1998 and 2001, before increasing in 2002 and 2003. Large multinationals in these sectors, such as Unilever, Colgate-Palmolive and Cadbury-Schweppes, have rationalized their workforce as they have shifted production to other African countries.

Linkages with foreign investors have been most significant between agroprocessing investors and the large domestic agricultural sector. Outgrowers are used extensively by horticulture packagers. It is estimated that purchases by leading exporters from smallholders account for 27 per cent of exported fresh vegetables and 85 per cent of exported fresh fruit.¹⁶ Homegrown, the country's leading horticultural producer, for example, uses around 1,000 outgrowers. The company operates a support policy for these outgrowers providing them with the seed, technical expertise and training necessary to produce a high-quality product. There are also supplier linkages in manufacturing, such as General Motors in automobiles (box I.3) and Tetrapak in packaging (box I.4). Backward linkage is limited in the textiles sector owing to the import of most raw materials from Asia. Cotton lint production declined from a high of meeting 100 per cent of demand in 1984 (70,000 bales) to 17 per cent in 2002 (20,000 bales),¹⁷ as local products cannot compete with cheaper imported lint.

¹⁴ World Bank (2003a).

¹⁵ Economic Survey 2004.

¹⁶ Jaffee (2003).

¹⁷ ITC (2002).

Box I.3 General Motors: Supply Chain Development

General Motors operates an assembly plant in Kenya that produces vehicles adapted to the local road conditions. Although vehicles are assembled from imported kits, GM Kenya makes extensive purchases from local suppliers. These total more than Sh1.5 billion (\$20 million) annually and involve ten key suppliers, all of whom are locally-owned (although one sells under a global brand-name and works under licence from a global TNC).

Following the global procedures of its parent, GM Kenya has an extensive supply-chain development programme. The purchasing department sets each of its suppliers key performance indicators – for example, on defect rates (parts per million). It also has seven engineers who:

- Visit every supplier at least once per year, audit production efficiency and make suggestions for upgrading;
- Visit any supplier that fails to meet its key performance indicator, in some cases also taking along production workers from its own lines to talk to the supplier and explain the problems which they experience with the defective materials. This helps the supplier to upgrade operations;
- Visit any supplier that is introducing a new product or a new specification of product in order to get production up to the required specification.

Source: investor interview.

Box I.4 Tetra Pak: Close Partnership with Local Supplier

Tetra Pak Kenya started their operation in the late 1950s by importing packaging material from Sweden. It became clear in the mid-1970s that packaging material had to be produced locally to support the growth of customers.

The main issue was the supply of raw paper, as it could not be found locally. This is when the local paper mill, Pan-African Paper, started operations, leading Tetra Pak to open a local packaging plant. However, Tetra Pak's technical specifications are extremely specific and demanding as the final product is to be used for sensitive liquid food-products, such as milk.

Very close collaboration then started with the mill and Tetra Pak. Experts were sent from Sweden to guide the mill, and make sure that quality controls were adequate and that the production process would result in the right parameters. Close collaboration and teamwork between both partners and commitment from both sides made it possible to have today close to 50 per cent of the company's paper requirement sourced from the Kenyan mill.

This resulted in a win-win situation: Tetra Pak was able to get local supply, saving greatly on logistics, and the mill was able to supply high-standard products not only to Tetra Pak but also to other customers.

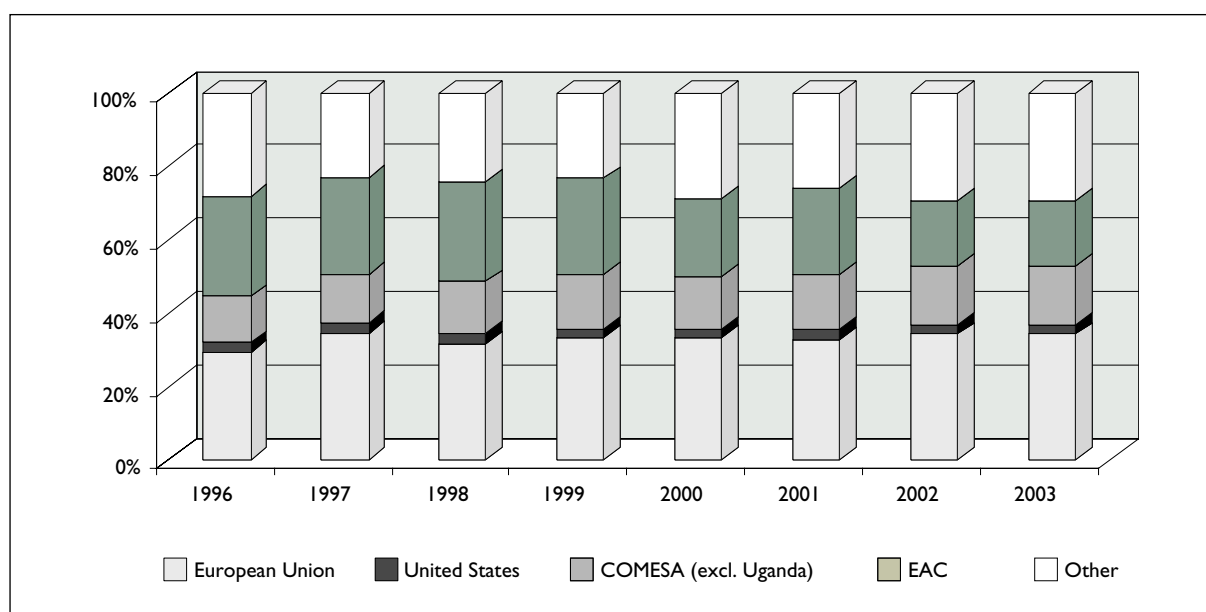
The collaboration continues today, with frequent meetings and exchange of ideas to keep improving all aspects of the partnership: logistics, supply and forecasting, to mention but a few. The latest example of this partnership is the production of a low grammage paper that Tetra Pak is now using for low-cost packaging.

Source: investor interview.

4. Diversification of Output and Exports

Since Kenya is a small economy, the country's development must be underpinned by trade. It is relatively open already, with total trade in goods and services (exports and imports) representing around 60 per cent of GDP over the past few years. Merchandise exports are dominated by a few key goods and markets, with FDI playing an essential role in the more dynamic sectors of horticulture and garments (figure I.6). Tourism and tourism-related services (mainly passenger air transport) account for the largest part of exports of services. Travel and passenger air transport services exports amounted to \$600 million in 2003, over 50 per cent of total exports of services. Foreign investors are active in all segments of tourism, including hotels, resorts, restaurants, travel and safari agencies. The success of Kenya Airways since its privatization in 1996 and the involvement of KLM of the Netherlands is also particularly notable. Exports of air passenger services, which is dominated by Kenya Airways, almost tripled between 1996 and 2003 as a result of the company raising the level and extent of its services and increasing the role of Jomo Kenyatta Airport as a regional hub.

Figure I.6 Composition of Merchandise Exports, 1996-2003
(Million dollars)



Source: Economic Survey 2004.

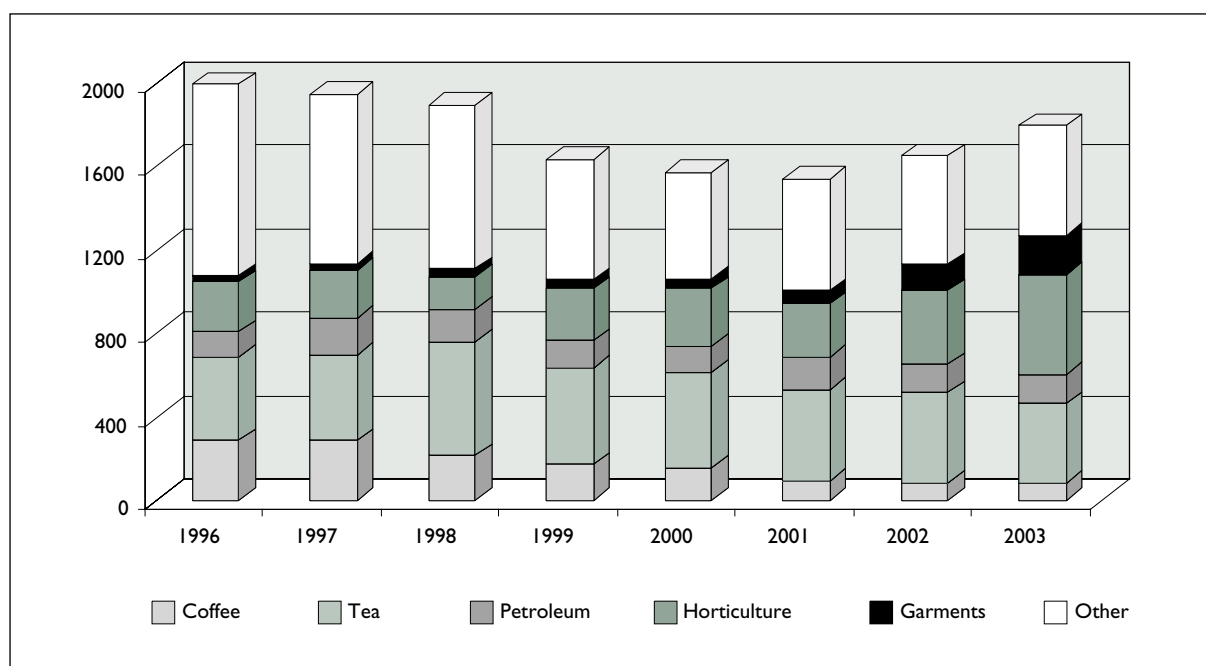
A notable fact in Kenya is the continuing importance of regional trade. Africa accounted for approximately 43 per cent of the country's merchandise exports in 2003 (figure I.7), with Europe accounting for 29 per cent. Exports to COMESA were 73 per cent of total exports to Africa. Within Africa, the largest trading partners were the EAC member countries, the United Republic of Tanzania and Uganda. The United Republic of Tanzania was the destination for 17 per cent of Kenyan exports to Africa and Uganda for 36 per cent. Exports to Africa are mainly manufactured consumer goods, in contrast to mainly agricultural produce to Europe and garments to the United States. Goods include beer, cigarettes, oils, perfumes, polishing and cleaning preparations, disinfectants, insecticides, and paper and paperboard.

Horticulture has become the country's main agricultural export, eclipsing tea and coffee. The export boom in flower and vegetables has been dominated by the production of foreign affiliates. Horticulture exports have grown rapidly in recent years, exceeding coffee exports in 1999 and tea in 2003.¹⁸ Cut flowers represent the

¹⁸ Economic Survey 2004.

largest share of volume (46 per cent), followed by fruits (37 per cent) and vegetables (17 per cent). Sales are in most part to Europe, accounting for 95 per cent of fresh produce exports. Kenya now accounts for 25 per cent of European flower imports from non-EU countries, exceeding significantly the share of the next two largest suppliers, Colombia (17 per cent) and Israel (16 per cent).¹⁹

Figure I.7 Direction of Exports, 1996-2003
(Percentage)



Source: Economic Survey 2004.

In recent years garments have become the country's fastest growing manufactured export in response to the AGOA agreement with the United States. Kenya's garments exports to the United States increased by more than 300 per cent to \$200 million between 2000 and 2003 (table I.5). Kenya is among the countries that have taken most advantage of AGOA to expand apparel exports to the United States, together with Lesotho, Madagascar and Swaziland. South Africa and Mauritius have also gained from AGOA by increasing their apparel exports to the United States, but to a lesser extent. Part of the reason is that neither of them benefits from the special rule for apparel that allows fabrics to be sourced outside AGOA-eligible countries or the United States and still benefit from preferential access. In 2003, Kenya was the fifth largest AGOA exporter of apparel to the United States, with about half the level of exports of Lesotho, and also behind Mauritius, South Africa and Madagascar.

Table I.5 Garments Exports to the United States since AGOA
(Number and million dollars)

	Number of firms	Export value
2001	17	69.0
2002	30	131.1
2003	34	201.7

Source: United States Department of Commerce and EPZA.

¹⁹ Stevens and Kennan (2004).

Box I.5 Homegrown Flowers: A Dynamic Horticulture Exporter

Homegrown is Kenya’s largest horticultural exporter. It produced 13,000 tonnes of the country’s 133,000 tonnes of horticultural exports in 2003. The company has invested \$52 million to date in the country and employs 6,000 people. It has an annual turnover in excess of \$40 million.

The company is owned by Flamingo Holdings, a United Kingdom-based vertically integrated horticultural business involved in the growing, processing, packaging, marketing and distribution of cut flowers and fresh vegetables. In addition to Kenya, the group sources produces from Zimbabwe, South Africa, Guatemala, Thailand, Spain and the Netherlands and now has a worldwide annual turnover of \$300 million.

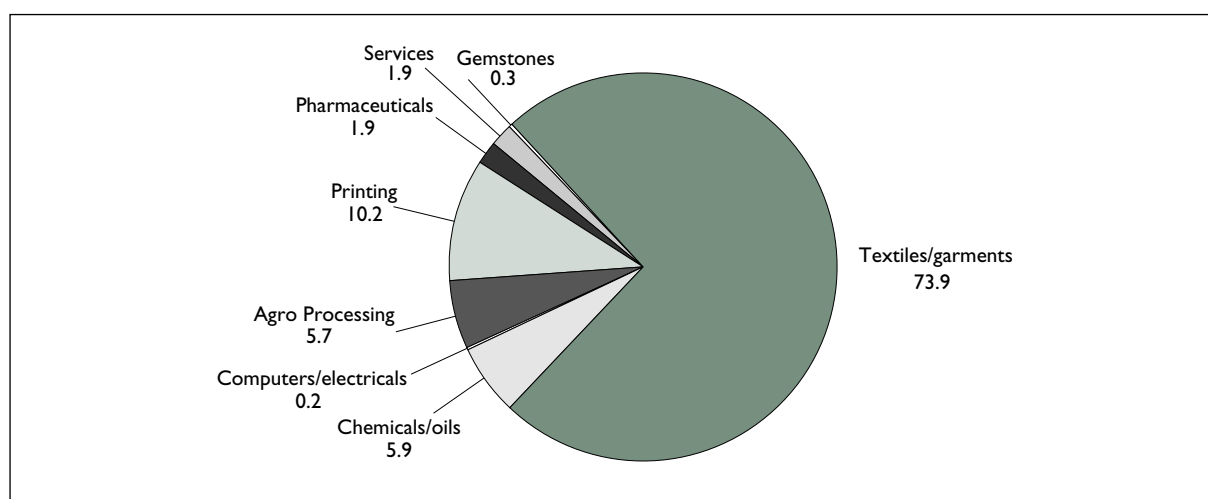
Homegrown grows flowers and fresh produce with the majority of the added value undertaken in custom-built facilities spread throughout Kenya. The fastest growing developments are in flowers, especially roses, which now represent 35 per cent of turnover, with high-quality prepared vegetable products providing 25 per cent of turnover, and premium prepacked vegetables the balance of 40 per cent of income.

Source: investor interview and company website.

Production has depended on the provision in AGOA allowing the use of non-African fabrics by local manufacturers until the recently extended date of 2007. Most raw materials are currently imported from Asia. Kenyan operations are mainly of a cut-make-trim nature, with foreign investors, mostly from Asia, using Kenya as a platform for quota-hopping to access the otherwise restricted US market. Quota-hopping motives, however, disappeared on 1 January 2005 with the integration of trade in textiles in clothing under normal WTO rules. The durability of these investments in garments is thus questionable as foreign investors also tend to be second-tier players in the textile industry and as most of them have minimized their capital investment by setting up relatively low technology facilities (see chapter III).

By the end of 2003 there were 66 EPZ firms.²⁰ The garments sector accounts for almost three-quarters of exports from the zones (figure I.8). There are a limited number of other investments of significance – notably

Figure I.8 Structure of EPZ Exports, 2002
(Percentage of total)



Source: Export Processing - Zone Authority

²⁰ Export Processing Zone Authority.

in security-printing (De La Rue) and in wattle processing. The EPZ contribution to the country's manufactured exports has increased steadily, from 5 per cent in 1997 to 38 per cent in 2003.²¹

D. Assessment

Kenya offers a contrasting picture of a country that has failed for the past two decades to attract significant levels of FDI but where a wide array of TNCs are nevertheless established and where foreign investors have played a key role in some of the few dynamic sectors of the economy. While Kenya was well positioned to attract regionally-oriented FDI in the 1960s and 1970s as a result of its economic leadership in East Africa at the time, poor or inconsistent economic policies, deteriorating infrastructure, poor growth performance and increasing corruption and insecurity discouraged foreign investment throughout the 1980s and 1990s.

Although Kenya's relative level of development and industrialization remains higher than in most other countries in the region, its economic leadership has eroded significantly over the past couple of decades. In particular, Kenya has been left behind in the global surge in FDI flows that started in the mid- and late 1990s and benefited its neighbours in the East African Community as well as much of Africa and the developing world.

Of particular concern is the fact that a range of existing foreign investors have been consolidating out of Kenya over the past few years and that few of them currently have significant plans for expansion. Also, while there are a few bright spots, they are few and far between, and some, like the recent rise in FDI in apparel production, may prove to be little more than a flash in the pan.

Urgent, decisive and sustained policy action is required in order to revive economic growth through both domestic and foreign investment. The bright spots such as foreign investors' involvement in horticulture, the airline industry or mobile telephony that have generated significant success in recent years show that FDI can play a major role in Kenya's economic development and wealth creation. They also show that Kenya has the potential, given appropriate policies and strategies, to attract significantly higher inflows of FDI and to turn itself again into a regional powerhouse in certain key sectors. Attracting a level of FDI per unit of GDP similar to that achieved on average by all developing countries in 1996-2003 would imply an annual inflow of \$400 million, over ten times as much as the level Kenya actually attracted in 1996-2003. In particular, it has the potential to build on four key strengths and opportunities, which are explored in chapters II and III and provide the basis for a medium-term development strategy:

- Its human resource base, which has the potential to be among the best in Africa;
- Its relative level of industrialization and economic development compared with neighbouring countries;
- Its membership of preferential trade agreements, including COMESA and the EAC;
- Its land and climate, which offer decisive comparative advantages in certain key agricultural sectors and in tourism.

²¹ Export Processing Zone Authority and Economic Survey 2004. The proportion is the EPZ contribution to industrial supplies (non-food) manufactured exports.

II. THE INVESTMENT FRAMEWORK

A. Introduction

Kenya's legal system is based on English common law. It is based mostly on sound principles, although in some areas it does not reflect modern approaches to regulating investment and commercial transactions. Actual practices also do not necessarily respect the spirit and principles of the law. The authorities have nevertheless made good progress in modernizing the legal regime in certain key areas over the past decade, including telecommunications, electricity and intellectual property. Parliament also adopted the Investment Promotion Bill at the end of 2004 and is currently examining a Privatization Bill.

B. Entry, Treatment and Protection of FDI

I. Entry and Establishment of FDI

For decades, Kenya had one of the most open regimes for FDI in Africa. The principal restrictions were contained in the Trade Licensing Act (1968, with subsequent amendments, box II.1), even though the FDI-related restrictions had not been enforced recently. Apart from this Act, the only formal limits on foreign ownership were in telecommunications and insurance (in which foreign ownership of a business is limited by policy to 70 per cent and 77 per cent respectively) and for companies listed on the Nairobi Stock Exchange, which are required to have at least 25 per cent national ownership. Moreover, FDI did not require screening for approval.

A new FDI entry regime was introduced in late 2004, which overturned this approach. As a result, one of the most liberal entry regimes for FDI in sub-Saharan Africa has been replaced by one of the more restrictive ones. The Investment Promotion Act (2004), which the President ratified on 31 December 2004, introduces a mandatory investment threshold and restrictive screening procedure for *all* foreign investments. These are set to become a significant impediment to FDI inflows. The Act makes a formal distinction between domestic and foreign investors, and requires the latter to apply to the newly established Kenya Investment Authority (KIA) for an Investment Certificate by stating that "a foreign investor shall not invest in Kenya unless [it] has been issued with an investment certificate".

The conditions under which KIA is allowed to issue an Investment Certificate to a foreign investor are restrictive and include the following requirements:

- The amount invested must be at least \$500,000 or the equivalent in another currency.
- The investment must be deemed by KIA to be to the benefit of Kenya, including *at least* as a result of: (1) the creation of employment for Kenyans; (2) the acquisition of new skills or technology by Kenyans and; (3) the contribution to tax revenues or other government revenues. Other factors such as the contribution to foreign exchange earnings or utilization of domestic inputs are to be taken into account as well, but are not part of the requirements unlike the three items listed above.

In contrast, domestic investors are not required to obtain Investment Certificates, but those that do not seek them are nevertheless required to register their investment with KIA. The minimum capital investment for domestic investors seeking an Investment Certificate is lower at Ksh5 million (\$65,000), but they must fulfill the same requirements to be deemed "beneficial to Kenya".

The screening and minimum capital investment requirements for all foreign investors and the reporting requirements for domestic investors were introduced through last-minute amendments to the initial draft Investment Promotion Bill (April 2004), which had been in preparation for several years and subject to substantial negotiations. These amendments thoroughly changed the spirit of the initial draft, whose thrust was to facilitate the establishment of new domestic and foreign investment.

Box II.1 The Trade Licensing Act

The Trade Licensing Act defines broad categories of “businesses”, which include trade in a wide range of goods (including sale by a manufacturer of his own goods), imports and exports, and any occupation as decided by the Minister of Trade and Industry. A licence is required from both citizens and non-citizens to conduct a “business”. In addition, the Act specifies that non-citizens shall not conduct a “business” outside a “general business area”, defined in the law to include parts of Nairobi, Mombasa, Nakuru, Kisumu, Eldoret and Thika, unless specifically authorized to do so in the licence. The Act also lists a range of about 70 “specified goods” (from foodstuffs to consumer and other manufactured goods) in which non-citizens are banned from conducting a business, whether within or outside “general business areas”, unless specifically authorized to do so in a licence.

As stated earlier, government policy has long been not to use the Trade Licensing Act to restrict access to foreign investors. In practice, trade licences are obtained free of charge and without delay from the Ministry of Trade and Industry, and foreigners are allowed to operate in all sectors and throughout the country. Licences are valid for periods of one to three years.

The Ministry does not allocate resources to enforce compliance with the licensing requirements, and it estimates that only about 50 per cent of businesses abide by them. This ratio is likely to be higher among foreign investors, however, particularly if they operate outside “general business areas” or in “specified goods” as this requires a special authorization, even though it is granted automatically. In essence, the trade licences system, which was devised to allow protection of small domestic businesses under the mixed-economy regime of the 1980s, has ceased to serve any purpose, as it is no longer used to restrict entry of foreign investors, generates a net cost to the Government (licences are free) and has little use in data collection given the low compliance rate.

The legislature introduced mandatory Investment Certificates and minimum capital requirements for foreign investors for several main purposes: (1) to maximize beneficial FDI and minimize its potential negative effects; (2) to give priority to national private sector development and to protect small national businesses in certain sensitive areas, and; (3) to ensure that the entitlement to work permits for foreigners granted as an incentive to holders of Investment Certificates is not abused to illegitimately bring in foreign workers.

The methods chosen under the Act to address these concerns, however, are set to have detrimental side effects on legitimate and beneficial FDI. The legitimate concerns, in turn, can and should be addressed in more targeted ways that do not negatively impact on FDI attraction, as is recommended in section D. A more investor-friendly approach would involve drawing up a strictly defined negative list of activities where foreign investment is restricted, leaving all other sectors open to FDI. Investment Certificates would be optional in the sectors open to FDI, but would remain a condition for obtaining special incentives.

Information collected by the Investment Promotion Centre (IPC) in 2000-2004 shows that 74 per cent of all projects, representing 21 per cent of foreign capital investment, were accounted for by investments of less than \$500,000. Under the new Investment Promotion Act, these projects would not be legally allowed. Pioneering small foreign investments that have led to the emergence of a world-class floriculture and horticulture sector, and have generated significant benefits through job creation, rural development, transfers of skills, access to markets and generation of export earnings, would not have been allowed had the current Act been in place in the 1980s-1990s. Homegrown, which employs over 6,000 people directly and accounts for about 10 per cent of Kenya’s floriculture and horticulture exports, started with an initial investment well below \$100,000 in 1982.

The \$500,000 requirement is most likely to negatively affect FDI in non-capital intensive projects in the services sector, which, as explained in chapter III, should be a strategic focus for Kenya's attraction of FDI. It will almost certainly also stimulate the practice whereby smaller foreign investors will engage citizens to "front" for them as owners of businesses. This could add to corrupting pressures on officials.

The requirement to screen all FDI proposals is a measure that is better applied to determine the eligibility for *incentives* (for qualifying investors) rather than to decide on the *entry* of FDI. It is not advisable in a market economy for a Government to prevent an investment because it does not create "sufficient" jobs or exports in the Government's opinion. It is a different matter to encourage investments that do have such positive impacts.

The other feature of the new Act is its incentive provisions, which are obtained through the granting of an Investment Certificate by KIA. These are twofold: (1) the granting of temporary business licences and; (2) the entitlement to six work permits for expatriates.

Under the Act, an Investment Certificate entitles the holder to the "deemed" issuance of a wide range of licences,²² as specified in the certificate, for an initial period not to exceed 12 months. Further, the certificate purports to *entitle* the holder to obtain actual licences within 12 months. The entitlement to licences is for the initial issuance only, after which the laws under which the licences are normally issued apply as usual, including as far as renewals and revocations are concerned.

Although it is aimed at facilitating investment, this approach is unlikely to achieve the Government's objectives and may create certain risks to Kenya. It is unlikely that investors will take the risk of investing until they have more certainty that the competent authorities will actually grant the licences within the 12-month period. More importantly, the issuance of certain preliminary licences without a full assessment may also be dangerous to Kenya in the sense that important matters of public interest can be involved in areas covered by licensing. This is partially recognized by the Act as it prevents KIA from including a licence in the Investment Certificate if the licensing raises environmental, health or security issues that are beyond its competence.

It is indeed not advisable for Kenya to allow investors to operate, even for an interim period, until a genuine assessment has been undertaken by the competent authorities in areas where licences are justified. An investment promotion agency is not in a position to grant even temporary licences in an area such as mining, to name only one example, which involve important matters of public interest that must be assessed carefully and professionally. In sum, the proposed system does not fully address the problem that it is intended to solve and investors still have to undergo the usual procedures to obtain licences to operate after the initial issuance. An alternative approach to the issue of licences and coordination between agencies is part of the recommendations at the end of this chapter.

The second incentive granted to holders of Investment Certificates is the entitlement to six work permits for expatriates. This is worthwhile and it follows practices adopted elsewhere. It is unfortunate that it has become linked to mandatory restrictions on *all* FDI, however. If there are concerns about illegitimate foreign workers entry through "convenience FDI", these can be addressed by granting the incentives to screened investors only, without the need to enforce screening and compulsory requirements on all investors, including those that would want to invest without benefiting from or qualifying for the incentives. This is elaborated upon in section 4.

In addition to this, the Investment Promotion Act transformed the IPC into the Kenya Investment Authority. It also instituted the National Investment Council (NIC) as an advisory body. The NIC will be chaired by the President (or a designated Minister) and include 23 members, of whom 11 are from the Government and 12 are from the private sector. The objectives of the NIC will include: (1) identifying areas of impediment to economic

²² The Act specifies 71 general or specific business licences that the holder of an Investment Certificate may be entitled to.

development and investment; (2) reviewing the economic environment and proposing incentives for investment; (3) monitoring industrial development; and (4) promoting cooperation between the public and the private sectors in the formulation and implementation of economic policy.

2. Treatment and Protection of FDI

The principle of national treatment of FDI is not enshrined in law. In general, however, foreign investors receive the same treatment as domestic investors once established in Kenya. The main deviation from national treatment (aside from those related to trade licences described above) is in terms of access to agricultural land.

The Land Control Act (1967, with subsequent amendments) specifically forbids non-citizens and private companies any of whose members is non-citizen to acquire or lease agricultural land. The Act nevertheless also allows the President to grant exemptions to the restrictions mentioned above, without having to provide justification or impose conditions on the transaction. His discretionary power in this matter is thus total and not limited by law.

Protection of private property, including for foreign investors, is enshrined in the Constitution. Private property may be compulsorily acquired by the Government only for reasons pertaining to public safety or public interest, and with “prompt payment of full compensation”. The owner of the property also has a right of direct access to the High Court if he wishes to contest the legality of the expropriation or the amount of the compensation, or to enforce prompt payment of the compensation. The draft Constitution, which is currently being discussed in a Commission, offers stronger protection yet, as it would require prompt payment in full of just compensation before the property is expropriated.

Foreign investors also have the option of recourse to the International Centre for Settlement of Investment Disputes (ICSID), as Kenya has been a member of the Convention since 1967. Recourse to ICSID for conciliation or arbitration requires the consent of both parties involved in the dispute, as specified by the ICSID Convention. The Investment Disputes Convention Act (1967) stipulates that awards granted by the ICSID Arbitration Tribunal are binding in Kenya and have the same validity as final decrees of the High Court. Kenya is also a member of the Multilateral Investment Guarantee Agency (MIGA), which allows foreign investors to seek cover for currency transfer risks, expropriation, breach of contract or war and civil disturbance.

Kenya has negotiated bilateral investment treaties (BITs) only with Germany, Italy, the Netherlands and the United Kingdom. Of these, only the latter two have been ratified and come into force. In contrast, Uganda has 11 BITs ratified or under negotiation, the United Republic of Tanzania 10 and Egypt 88. The provisions in the BITs are standard in that they provide for national treatment as regards management, maintenance, use, enjoyment or disposal of investment, most-favoured-nation status and compensation for war, national emergency and other related losses. They also guarantee transfer rights and provide protection against arbitrary expropriation and prompt, adequate and effective compensation in the event of expropriation. The BITs usually bind the States to consent to international arbitration to ICSID if the investor requests it, and if local remedies have been ineffective after a set period of time (typically a few months). As of the end of 2004, only one case had been filed to ICSID, by the World Duty Free Company Ltd, relative to issues of bribery in connection with the Goldenberg case.

C. General Measures for Regulating Business

I. Taxation

Kenya’s tax system is relatively straightforward and is not widely used to provide targeted sectoral incentives. The administration of the system is efficient and fair relative to other developing countries. Kenya compares favourably with other countries in the region and elsewhere in terms of revenue collection as a percentage of

GDP, which averaged 21.2 per cent between 2000 and 2003 (table II.1). It relies relatively heavily on customs and excise duties, which represent close to 50 per cent of total revenue, although this is also the case among comparable countries.

Table II.1 Government Revenue (excluding grants)
(Percentage of GDP)

	1999	2000	2001	2002	2003
Kenya	26.4	23.1	21.9	20.6	19.3
Colombia	13.3	13.3	15.3	15.5	15.8
South Africa	25.3	23.9	25.0	25.0	24.4
Sri Lanka	17.7	16.8	16.4	..	..
United Republic of Tanzania	10.7	10.7	11.2	11.1	..
Uganda	10.9	11.3	10.6	11.5	..

Source: IMF, International Financial Statistics.

Investors' concerns about the tax regime are focused less on the structure of the system itself or the level of taxation, and more on what they perceive as a rather "aggressive" attitude of the Kenya Revenue Authorities (KRA) with respect to compliant tax payers, and the "punitive" levels of penalties in the event of delay in payments or minor mistakes in reporting. They often perceive KRA as expending too much effort on chasing existing taxpayers at the expense of its efforts to widen the tax base. They also raised concerns about delays in reimbursements of excess VAT payments and duty drawbacks, and the administration of customs. The overall efficiency and competence of the KRA must be commended, however, as efficient tax collection is key to the functioning of the economy.

a. VAT

Value-added tax was introduced under the Value Added Tax Act (1990, with subsequent amendments) in 1990 to replace the sales tax. The law reflects modern principles of VAT structure and administration. The main structural weakness resides in the absence of clear accompanying regulations on transfer pricing (more on this issue in subsection b.).

VAT is levied on both goods and services, whether they are produced domestically or imported, while exports are zero-rated. Certain goods, mostly basic foodstuff and machinery, are exempt. Goods and services subject to VAT are taxed at 0 per cent (foodstuffs, medicine and agricultural inputs), 14 per cent (hotels and restaurant) or 16 per cent.

Businesses are required to register under the VAT Act if their sales of taxable goods exceed Sh3,000,000 (\$40,000) per year, or if they deal in a list of prescribed goods or services. The administration of the VAT system follows standard international practice, which requires businesses to charge their customers VAT and allows them to deduct input taxes from output taxes in calculating their monthly returns. Refunds are granted only to businesses that provide zero-rated supplies or those that have incurred physical capital investment whose input tax exceeds Sh1,000,000 (\$13,000). This includes exporters, which are the major claimants of VAT refunds. Other businesses recoup the excess payment from their subsequent returns.

The KRA has been allocated Sh480 million (\$630,000) per month for VAT refunds over the past couple of years. This has been insufficient to clear the backlog of refunds, even though administrative problems also play a role in delaying refunds as the annual appropriations for refunds were not fully disbursed over the past two fiscal years. The KRA reports that it takes on average between three and six months to process refund claims. This delay is one of the major grievances raised by investors about the administration of the VAT system. The monthly amount allocated for refunds was recently increased to Sh700 million (\$920,000), however, and the

KRA streamlined the refund payment system so that claims are queued and payments made on a first-in first-out basis.

Investors are also concerned by what they perceive as punitive penalties on delays on their part. The VAT Act imposes penalties of 2 per cent per month compounded on late payments. The Act also allows the VAT Commissioner to recover unpaid tax liabilities by seizing assets instead of suing the taxable person.

b. Corporate Income Tax

The structure of corporate income taxes is straightforward and in line with standard international principles in terms of reporting of income, deduction of expenses and investment allowances. The authorities have used the corporate income tax regime and investment allowances sparingly to provide targeted incentives to priority sectors. The framework for income tax (both personal and corporate) is set in the Income Tax Act (1974, with subsequent amendments).

Resident companies are taxed at a rate of 30 per cent of earnings, regardless of sector of operation and ownership, while local branches of non-resident companies are taxed at a rate of 37.5 per cent. The only concessions on the corporate income tax rate are granted to companies operating in export processing zones (see section C.1.c) and to companies newly listed on the Nairobi Stock Exchange, which are taxed at either 25 per cent or 27 per cent for five years from the year of listing if they float a minimum of 30 per cent or 20 per cent of their capital, respectively. Services providers are also subject to a 5 per cent withholding tax on agency or consultancy fees when the transaction involves two resident entities. Although this is an advance tax as the withholding is credited when income tax returns are filed at the end of the year, it significantly affects the cash flow of the service provider.

The corporate income tax base is assessed on the basis of deductions of “all expenditure incurred in that year of income which is expenditure wholly and exclusively incurred by him in the production of that income”, following standard international practice. Deductions are allowed for bad debts, depreciation of capital or contributions to a national provident fund on behalf of employees, amongst others.

The allowance for depreciation of capital is fairly standard across sectors, with some modifications for mining and farming. Manufacturing and hotels also benefit from accelerated depreciation rates. The standard regime for investment allowances is as follows:

- The cost of buildings or supplemental work on buildings (roads, water or communication facilities, ...) can be depreciated on a straight-line basis at the rate of 2.5 per cent per annum. Hotels qualify for an accelerated rate of 4 per cent per annum.
- Most machinery qualifies for depreciation at a rate of 37.5 per cent per annum on a declining balance basis.
- IT equipment qualifies for depreciation at a rate of 30 per cent per annum on a declining balance basis.
- Vehicles and aircraft qualify for depreciation at a rate of 25 per cent per annum on a declining balance basis.
- Other office equipment and furniture and ships qualify for depreciation at a rate of 12.5 per cent per annum on a declining balance basis.

The manufacturing sector also benefits from an “investment deduction” for expenditure on buildings and other capital spending (as listed above), while hotels benefit from the investment deduction on buildings only. The investment deduction is an accelerated rate of depreciation in the first year. As of 2004 and until 2008, the investment deduction allows a 100 per cent rate of depreciation in the first year. This rate has fluctuated widely in the past, sometimes according to the region in which the investment takes place.

Other provisions in the income tax law are relatively favourable to investors: loss carry forward is not bounded in time, and the capital gains tax has been suspended since 1985. The withholding tax on dividends is 10 per cent for dividends paid to non-residents and 5 per cent for dividends paid to residents. Agency or management fees (business or professional services), in turn, are subject to a withholding tax of 20 per cent for non-residents (table II.2).

Table II.2 Withholding Tax Rates Under General Regime and DTTs
(Percentage)

	Dividends, individuals, companies	Dividends, qualifying companies	Interest	Royalties	Professional fees
General	10	10	15/25	20	20
DTTs:					
Canada	25	15	15	15	
Denmark	30	20	20	20	
EAC ¹	15	15	20	20	20
Germany	15	15	15	15	15
India	15	15	15	20	17
Norway	25	15	20	20	
Sweden	25	15	15	20	
United Kingdom	15	15	15	15	12.5
Zambia	exempt	exempt	exempt	exempt	exempt

¹ Tripartite treaty, signed but yet not ratified by Uganda.
Source: Income Tax Act and DTTs.

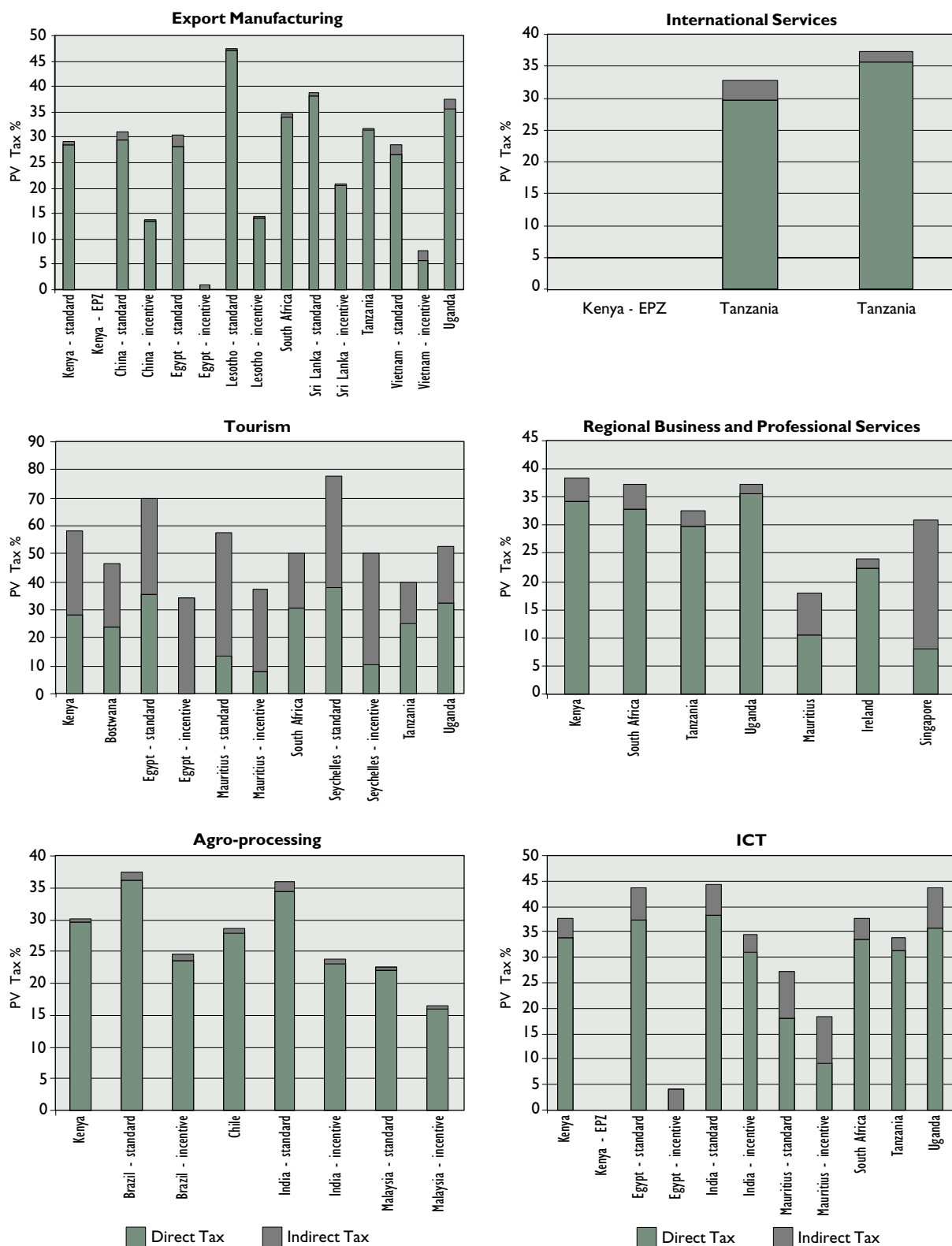
Kenya has signed eight double taxation treaties (DTTs), including with major source countries of FDI such as the United Kingdom, Germany and Canada, but including only one African country (Zambia). The treaties allow for the taxation of dividends, royalties, interest and management fees in both contracting States but set limits on the withholding rate allowed in the country where the income arises. These limits are typically higher than what Kenya applies in its general regime, except for management fees. All DTTs allow for tax credits for tax paid in the partner country.

Negotiations for DTTs with Italy, the United Republic of Tanzania and Uganda were initiated over a decade ago, but have not been concluded. Investors based in Kenya and with subsidiaries or sources of income in the United Republic of Tanzania, Uganda or any other neighbouring country thus face double taxation, which can raise the effective tax burden up to 51 per cent (e.g. 30 per cent corporate income tax rate in the United Republic of Tanzania or Uganda, and another 30 per cent in Kenya). Kenya does not offer unilateral foreign tax credits to companies with taxable income in countries with which it does not have DTTs. The absence of DTTs with neighbouring countries thus constitutes a significant impediment to business expansion in the region. A trilateral tax treaty with the United Republic of Tanzania and Uganda to avoid double taxation was signed 1997, but it has not entered into force as it has been ratified by Kenya and the United Republic of Tanzania, but not Uganda. Additional negotiations are under way with South Africa, Nigeria, Mauritius and France.

A comparative assessment of the burden of direct and indirect taxes is carried out by measuring the discounted present value of taxes paid as a percentage of pre-tax cash flow (PV tax, per cent; see annex I), assuming hypothetical investments with a 10-year lifetime in various sectors. The results are shown in figure II.1: the higher the percentage of the PV tax, the less competitive the fiscal regime.

The relative straightforwardness of Kenya's tax regime appears clearly from figure II.1, as the "standard regime" yields a relatively similar tax burden across the six sectors taken into account. The higher corporate tax burden on regional business and professional services and ICT reflects the more favourable treatment

Figure II.1 Comparative Taxation of Investment, 2004



of investment depreciation in manufacturing and tourism. There are only minor differences in the burden of direct taxation across sectors, with slightly higher variations in the burden of indirect taxation. In particular, the tourism sector is affected by a high burden of indirect taxes, as typical imported inputs are subject to relatively high duties.

Kenya's tax burden in the standard regime, at around 30-35 per cent, is also relatively competitive across all the sectors analysed in figure II.1. This is true when compared with regional competitors (South Africa, the United Republic of Tanzania, Uganda), and also when compared with global competitors in the respective sectors considered (India, Thailand, Singapore, Brazil, Chile). This analysis formally confirms results based on investor surveys and interviews, which showed that the burden of taxation is not per se a major impediment to FDI, even though there are selected issues of concern to some investors.

Figure II.1 also highlights the extreme nature of Kenya's incentive regime based on export processing zones (EPZs). The entire incentive regime analysed in figure II.1 is based on EPZs as the Income Tax Act provides for very few and minor sectoral incentives for companies operating outside EPZs. EPZs are open to all investors in manufacturing and services (see section c.) and offer such extensive fiscal incentives that the tax burden (direct and indirect) for exporters falls to zero over an initial period of ten years. Although designed only for exporters, this regime is unusually favourable.

Although the tax regime is generally appropriate and competitive, both within the region and globally, a few issues raise significant concern for investors and are impediments to the use of Kenya as a business platform for the region. The main concerns that need to be addressed include:

- Double taxation on profits or income from operations within the region. The absence of unilateral tax credits and DTTs with partners in the region is a major impediment to the development of Kenya as regional hub. Ratification of the EAC treaty and the conclusion of DTTs with other countries in the region are essential in order to realize Kenya's ambition to become a regional hub for manufacturing and services activities. Until the EAC treaty is ratified and additional DTTs are negotiated with countries in the region, the authorities would be well advised to allow unilateral foreign tax credits to the extent of the amount of foreign tax paid on the income derived from foreign operations.
- The imposition of a 5 per cent withholding tax on agency and consultancy fees between two resident entities is another impediment to the development of a regional services hub, in particular when potential refunds following income tax returns are processed slowly. The withholding tax generates a heavy burden on the cash flow of nascent services companies that may not generate significant profits and hence qualify for refunds once income tax returns are filed. A less detrimental way to ensure tax compliance would be to impose a relatively small nominal withholding tax on agency and consultancy fees, not to exceed a specified percentage of 1 to 2 per cent of the amount, whichever is lower.
- A major weakness of the Acts as far as international investors are concerned lies in the issue of transfer pricing. The VAT Act stipulates that the taxable value of goods traded among affiliated companies should be "the price at which the supply would have been provided in the ordinary course of business to a person independent of the registered person". The Income Tax Act, in turn, seeks to prevent tax evasion by stipulating that "the gains or profits of that resident person from that business shall be deemed to be the amount that might have been expected to accrue if the course of that business had been conducted by independent persons dealing at arm's length". However, the KRA has not determined clear guidelines on how companies should determine transfer prices and has not adopted the widely accepted OECD principles. This absence of guidelines remains a concern to investors, who currently face uncertainty regarding KRA's position vis-à-vis their methods of assessing transfer prices, and hence their tax base. A clear position from KRA on such an important and sensitive issue is required in order to reassure investors and is an indispensable part of a modern and enforceable tax code. An OECD training

programme for EAC tax authorities to be held in May 2005 should be used as a building block for the adoption of modern transfer pricing principles.

c. Export Processing Zones

Special incentives are provided for enterprises operating in Export Processing Zones under the Export Processing Zones Act (1990, with subsequent amendments). Three types of activities can be carried out in EPZs: manufacturing, services and commercial. In addition to procedural incentives (exemption from certain licences, facilitation services by the Export Processing Zones Authority) and the higher quality of infrastructure, the following fiscal incentives are granted to companies operating in EPZs:

- Exemption from "all existing and future taxes and duties payable under the Customs and Excise Act and Value Added Tax Act on all export processing zone imports for use in the eligible business activities of the EPZ enterprise".
- Exemption from registration under the VAT Act.
- Exemption from the payment of income tax for the first 10 years from the date of first sale, followed by a rate of 25 per cent for the subsequent 10 years and the standard rate thereafter.
- Exemption from the payment of withholding tax on dividends and other payments made to non-residents for the first 10 years.
- Exemption from stamp duty.
- Exemption from any quotas or other restrictions or prohibitions on imports or exports, with the exception of trade in firearms, military equipment or other illegal goods.

EPZs are considered "extra territorial" in the sense that goods and services purchased from Kenya are treated as Kenyan exports, hence payable in convertible currency. The EPZ Act allows goods produced in EPZs to be sold in Kenya, but they are then treated as imports from a third country and hence subject to usual customs procedures and payments of VAT and duties at most-favoured-nation (MFN) rates. At the moment, EPZA's policy is to approve projects for setting up in EPZs if a minimum of 80 per cent of output is to be sold outside Kenya. The percentage of output that can be sold domestically is typically specified in each enterprise's licence.

The 2004 Finance Bill (fiscal year July 2004-June 2005) imposed an additional 2.5 per cent charge on sales from EPZ enterprises to the Kenyan market, on top of the MFN duties. It also proposes that the EPZ Act be amended to require ministerial approval for sales of goods to Kenya from a zone, a provision that already applies to services.

Exports of EPZ companies outside Kenya are treated in a standard way despite the EPZs' extra territorial status. This allows exports to EAC and COMESA at preferential rates, as if the goods were originating from Kenya, subject to rules of origin. The same treatment applies to exports to other trade zones or countries, which give EPZ companies Kenyan status and subject their goods to rules of origin to determine the applicable tariff rates.

d. Customs Duties

Imports were subject to seven tariff bands ranging from 0 per cent to 35 per cent until the end of 2004, with a weighted average MFN tariff of 13.3 per cent in 2001. However, under the protocol establishing the East African Community (EAC) Customs Union signed in March 2004, Kenya, the United Republic of Tanzania and Uganda adopted a common external tariff starting on 1 January 2005. Raw materials and capital goods are now subject to a tariff of 0 per cent, with intermediate goods and final consumer goods taxed at 10 per cent and 25 per cent, respectively.

As for VAT and income tax, investors raised the concern that KRA's focus on revenue collection is at the expense of other services/functions it should serve. In particular, the customs administration plays a crucial role beyond raising revenue, as it is crucial to facilitating trade and ensuring the enforcement of quality standards on imported goods. While organizational performance is regularly and comprehensively assessed on the basis of revenue targets, the customs department does not systematically benchmark its performance on clearance time or keep track of compliance by traders, which prevents it from carrying differentiated physical inspections based on track records.

The KRA nevertheless carried out a clearance time study in late 2004, as part of its Customs Reform and Modernization project and with technical support from the World Customs Organization. The study showed average times from arrival to removal of 10 days in Mombasa and 5 days at Jomo Kenyatta Airport. Pre-lodgements of documentation with the authorities, however, halved these clearance times. The study identified the main causes of delay as the large number of agencies involved in clearance procedures, computer breakdowns, cargo scanning or misdeclaration by importers. It initiated a review of procedures with a view to automating them and recommended introducing risk management methods (differentiated physical inspections) and post-clearance audits.

A customs duty drawback scheme is available to exporters. It allows domestic producers to claim exemptions (subject to a bond) on the payment of customs duties on their imported operating inputs. The scheme also allows domestic providers of inputs to direct exporters to claim exemptions on their own imported inputs, in order to encourage linkages between direct exporters and local suppliers. Exemptions for domestic suppliers of inputs to direct exporters can go back two stages of production, i.e. transactions either directly from a local supplier to a direct exporter, or from a local supplier to another local supplier providing input to a direct exporter.

2. Foreign Exchange Arrangements

Kenya switched from a fixed exchange rate regime (1966-1982) to a crawling peg tied to a basket of major currencies (1983-1993) before floating the Shilling in October 1993. It fully liberalized capital account transactions in 1994 and signed up to the IMF's Article VIII, which ensures currency convertibility for current account transactions and bans multiple currency practices. The Exchange Control Act was repealed in 1995, and all foreign exchange transactions are free of any restriction.

There are no multiple currency practices, and the exchange rate is freely determined in the inter-bank foreign exchange market. The Central Bank of Kenya reports very little in terms of intervention on the inter-bank market to stabilize the Shilling. Its intervention occurred mainly in the years following the floating of the Shilling, and it reports only three interventions in 1999, six in 2000 and only one other intervention since then. The Shilling has nevertheless remained relatively stable against the dollar in recent years, as it depreciated from about Sh60/\$1 in late 1998 to trade in a range of Sh73/\$1 to Sh79/\$1 between early 2000 and early 2005.

3. Labour Regulation

Labour market regulations offer a mix of flexibility in hiring and firing procedures with significant rigidities in the setting of minimum wages and indirect labour costs. In general, investors concur that labour relations are good and do not constitute a major source of problems. About 66 per cent of investors surveyed by the World Bank in 2000 in the World Business Environment Survey (WBES) stated that labour regulations were "no obstacle" or a "minor obstacle" to their operation and the growth of business. This is in sharp contrast to other countries in the region where labour disputes are more prevalent, in particular South Africa and the United Republic of Tanzania, where 85 per cent and 55 per cent of investors, respectively, stated that labour regulations were a "moderate obstacle" or "major obstacle".

The definition of gross misconduct that can justify summary dismissal for a lawful cause is relatively wide and includes absenteeism and neglect in performing duty. Termination of employment through redundancy, in contrast, is more rigid as it is considered a trade dispute in all cases, regardless of whether there is an agreement between the employer and the employee(s) or not. This implies that all redundancies must be reported to the Ministry of Labour, which can either confirm the terms of the redundancy or invoke a settlement procedure if necessary. This procedure may involve a direct attempt at conciliation, or referring the case to the Industrial Court. Standard terms for redundancies require employers to pay two weeks of salary per year of employment.

Although labour is relatively unionized, the Trade Disputes Act (1965, with subsequent revisions) restricts the right to strike and lock-outs. Until 2003, employees in EPZ companies were not allowed union representation. Industrial unrest in many EPZs, however, pushed the Government to lift the exemption, and all labour regulations currently apply equally to EPZ enterprises.

In addition to wages, employers are required under the Employment Act (1976, with subsequent amendments) to provide their employees with: (1) "reasonable housing accommodation" at or near the place of employment; (2) access to water; and (3) "proper medicines during illness and medical attendance during serious illness". In practice, most employers provide their employees with a housing allowance and private medical insurance.

Minimum wages are set separately for three regions: (1) Nairobi and Mombasa; (2) a number of the main municipalities and townships; and (3) all other areas of the country. While this regional differentiation in minimum wages is sensible given the wide regional disparities in cost of living, the Regulation of Wages and Conditions of Employment Act (1951, with subsequent amendments) also sets minimum wages for a near-exhaustive list of professions and functions. This level of detail is not justified and introduces unnecessary rigidities and administrative costs.

Minimum wages also appear relatively high compared with other countries at a similar level of development; this affects Kenya's competitiveness in low-skill, labour-intensive sectors subject to global competition and thin profit margins. As of 2002, the minimum monthly wage ranged from about \$24 for unskilled workers to \$84 for a higher skilled position. Additionally, total labour costs are further increased by the allowances described above, as illustrated by average earnings data by sub-sectors (table II.3).

Table II.3 Estimated Average Monthly Earning by Sectors
(Dollars)

	1998	1999	2000	2001	2002
Agriculture and forestry	73	72	77	88	101
Coffee plantation	61	60	62	70	78
Mining and quarrying	103	97	102	117	136
Manufacturing	169	167	176	198	222
Agro-processing	101	101	108	123	141
Spinning, weaving	113	111	118	133	148
Apparel	130	135	149	176	209
Wholesale, retail, hotels	239	238	259	307	366
Construction	149	147	160	186	218
Finance & business services	330	332	349	415	497

Source: Central Bureau of Statistics, Statistical Abstract, 2003.

The Ministry of Labour is planning to consolidate the four Acts discussed above, as well as two other minor Acts, into three Acts (Employment Bill, Labour Relations Bill and Labour Institutions Bill) that have been drafted with technical assistance from the International Labour Office (ILO) and are now in the Attorney General's

office prior to being presented to Parliament. The draft Employment Bill maintains many of the characteristics of the existing employment Act, including provisions for housing allowance, access to water and medical coverage.

The grounds for summary dismissal remain essentially the same, and only slight changes would be made in the procedures for redundancies, while six-month probationary contracts would be introduced. The draft Labour Relations Bill would provide further tools for conciliation of labour disputes and modernize the regulation of trade unions and employers' organizations. Disputes referred to the Ministry would be first subject to an attempt at conciliation for a period of at least 30 days, with the conciliators allowed to summon people to meetings and make recommendations as well as concrete proposals for settling the dispute.

The draft Labour Institutions Bill preserves the Wages Councils, which are currently in charge of setting minimum wages. The Ministry of Labour stated that the policy of setting detailed schedules for minimum wages across sectors, functions and regions would be maintained. The repeal of the Regulation of Wages and Conditions of Employment Act is an opportunity to reconsider the current approach to minimum wage setting. A schedule of minimum wages across three regions and a few broad sectoral activities for low-skilled employees should provide adequate protection to workers and allow a higher degree of flexibility in labour markets.

4. Employment of Foreigners

Kenya follows a rather dated approach to granting work permits that creates uncertainty for applicants. This was reflected in interviews with foreign investors, as some reported no difficulties in obtaining work permits, while in other instances investment was frustrated by such problems, particularly in the services sector. There are essentially two types of permits that can be granted under the Immigration Act (1967, with subsequent amendments), which consolidate work permits and entry permit into a single pass:

- Class A or D permits can be granted to an individual who is offered specific employment by a specific employer.
- Class F to J permits are essentially "investors permits" for individuals who propose to invest in different types of activities, from agriculture to manufacturing or professional services. The Immigration Act does not prescribe any minimum amount of investment for such permits, although it specifies that the individual must have "in his own right and at his full and free disposition sufficient capital and other resources for the purpose".

Applications for work permits are examined on a case-by-case basis by a Committee chaired by the Department of Immigration, and which includes representatives from the Ministries of Foreign Affairs, Labour, Tourism, Trade and Industry and the Investment Promotion Centre. While the Immigration Act specifies that work permits can be granted to foreigners on condition that "employment will be of benefit to Kenya", the concept is not clearly defined by law. There are also no publicized guidelines as to how "benefit to Kenya" is to be understood. This increases the degree of discretion granted to the Committee and the level of uncertainty for investors.

A single application is filed that justifies the merit of hiring an expatriate for the position and the merit of the individual proposed for the position. The petitioner must justify the steps that have been attempted to fill the position with a Kenyan citizen and why this has not been possible. This involves, in most cases, an extensive labour market test and requires advertising the position domestically, collecting curricula vitae and interviewing citizens. In some instances, for example high technologies, where local skills are in obvious shortage, this requirement may be bypassed.

The granting of work permits to non-citizens is also conditional on a rigid understudy programme. Petitioners are required to recruit or designate a Kenyan employee as an understudy to the expatriate worker, with the aim of replacing the latter in a specified period of time. This arrangement has proved very rigid and is

susceptible to many problems ranging from the understudy leaving the company before being trained to replace the expatriate employee to lack of competence of the individual, or manoeuvring by the firms to avoid replacing the expatriate with the understudy.

Work permits are typically issued for a two-year period that can be extended to a maximum of five years. They are also renewable. Circumstantial evidence from investors' experience tends to show that work permits are easier to secure when the capital investment is significant or when the investment is likely to generate significant export earnings. The immigration authorities also indicated that they tend to be more liberal in granting work permits for companies operating in export processing zones, as they tend to generate both a high level of employment for citizens and foreign currency earnings. Investments in services sectors that require a smaller injection of capital are scrutinized more carefully as the authorities fear an inflow of illegitimate workers. However, this seems to have also generated problems for legitimate investors in the skill-intensive but low-capital services sector in securing work permits.

Although the procedure for allocating work permits is rather cumbersome and discretionary, data show that the immigration authorities have issued a relatively significant number of work permits in relation to the total workforce in employment in the past few years. The number of employee permits granted has hovered around 6,500 a year, with about 2,500 investor permits allocated every year (table II.4). These figures include renewals, however, which means that the pool of expatriate workers has decreased slightly over the past few years. This situation could thus be responsible for frustrations for new investors, who are likely to face greater problems in securing new permits than established investors face in obtaining renewals. The estimated number of expatriates working in Kenya relative to the total labour force in private sector formal employment is about 1.2 per cent for expatriates under A or D permits, and about 0.5 per cent for expatriates under "investor's permits".

Table II.4 Allocation of Work Permits
(Absolute numbers, unless specified)

	1998	1999	2000	2001	2002	2003
A&D, including renewals	7 342	5 452	6 504	6 116	6 591	5 134
A&D, stock as % of wage employment (est.) ¹	1.6	1.3	1.2	1.2	1.2	n.a.
F-J including renewals	2 635	2 061	2 162	2 970	2 938	2 489
F-J, stock as % of wage employment (est.) ¹	0.6	0.5	0.4	0.5	0.6	n.a.
Total private sector wage employment	967 200	989 900	1 002 900	1 018 700	1 040 900	n.a.

¹ Outstanding stock of work permits is estimated on the assumption that all permits have a 2-year validity. The sum of all permits granted over the previous 2-year period should thus indicate the outstanding number of permits in any given year.

Work permits granted to staff of embassies, the United Nations or missionaries are excluded from the data.

Source: Department of Immigration.

The new Investment Promotion Act entitles holders of Investment Certificates (whether foreign or domestic investors) to three class A (employee) permits for management or technical staff and three class H, I or J (investors) permits for owners, shareholders or partners. The permits are to be issued for an initial period of two years, and holders of certificates are entitled to have the permits renewed or transferred to another employee or investor if necessary, without time limit. Security, credentials and health checks on nominated individuals will obviously still be conducted following regular procedures.

The entitlement to six permits is a step in the right direction. It will greatly facilitate the key foreign personnel requirements of foreign investors. This "key position" approach is increasingly used in other countries. The unusual feature of the Kenyan law is that this *incentive* mechanism has been extended into an outright ban on all foreign investment below the prescribed limit of \$500,000. Elsewhere in this report it is recommended that the outright ban be reconsidered. If this occurs, a lower threshold for eligibility for key positions should also be considered. In other countries the thresholds are lower and key position entitlements increase with the size of the investment. Such a "sliding-scale" approach to entitlements to foreigners' work permits is recommended

for Kenya. Conditioning the entitlements to screening by KIA and the Investment Certificate would ensure that the system is not abused to illegitimately bring in foreign workers.

Quite apart from the innovation of the “key position” system other features of work and residence policies would benefit from a more modern approach:

- The labour-market testing procedure should be replaced, at least for high-skill positions and jobs, with an Australian-type approach whereby a *pre-determined* list of skills shortages is drawn up. Investors seeking foreign employees of such kinds would not be required to demonstrate by an exhaustive local recruitment campaign that suitably qualified citizens were unavailable. With appropriate safeguards, approved employers would be entitled to hire such foreign workers, subject only to verification of the credentials and character of the individuals proposed for employment by the Immigration Department.
- The understudy programme as it is currently structured fails to ensure that Kenya derives maximum benefits from the presence of foreign workers in terms of transfers of skills and knowledge. The system excessively relies on individual factors and imposes too much rigidity on investors. Instead, Kenya should impose a much more flexible and company-wide system of transfers of skills and training of employees. Investors may be required to spend some minimum amount, proportional to turnover, on training of Kenyan employees, but it should be left to them to determine where the skill-shortage lies (among what types of employees and for what types of skills) and how they want to remedy it. This is much more likely to enhance the profitability of businesses and encourage transfer of skills on a widespread scale than a rigid and individually based understudy programme.

5. Land

Access to land and the administration of land ownership titles raise serious concerns for foreign and domestic investors alike. As in other cases, the experience of foreign investors seems to be mixed, which is another reflection of the degree of discretionary powers granted under the law to its administrators. Land classification falls under three categories: government land (20 per cent of the total), trust land (held by county councils, 60 per cent of the total) and private land (20 per cent of the total). There are also three main ownership titles: freehold, leasehold (generally, but not exclusively, 99 years) and customary tenure (which varies by region and ethnic groups).

The issues regarding access to agricultural land and land for industrial or offices purposes are quite distinct and are thus dealt with separately. Transactions in agricultural land are regulated by the Land Control Act (1967, with subsequent amendments). All areas of agricultural land, as defined by the Minister of Land, are administered by a Land Control Board, which must give its consent to all transactions, including sale, transfer, lease, mortgage and partition.

Aside from ensuring that agricultural land is actually used for agricultural purposes, land control boards are specifically required by the Land Control Act to refuse their consent to any transaction that involves either a non-citizen or a private company or cooperative any of whose members are non-citizens. The very same Act, however, also gives full discretionary powers to the President to grant exemptions to any controlled transactions (including transactions involving foreigners) on a case-by-case or more general basis without being required to provide justification, and “on such conditions (if any) as he may think fit to impose”.

Presidential exemption is thus the main channel through which foreign investors can acquire agricultural land. There are no procedures and publicized guidelines that investors can follow, however, as applications are considered on a case-by-case basis and on their own merit. Initial access to the Presidency is obviously the first hurdle to clear for foreign investors, as no clear procedure exists. The lack of guidelines in the granting of exemptions and the involvement of a number of Ministries (including the Ministries of Environment, Home Affairs and Land) also make the process very unpredictable and lengthy.

The level of discretion and the uncertainty in administering transactions in agricultural land involving foreigners are characteristic of much of the investment environment in Kenya. As a result, investors' experiences have been very mixed. Some investors, mostly well established already, reported no problem relating to access to agricultural land, while others reported it as being a serious issue, with a least one case of an investment project being aborted for lack of access to the Presidency in petitioning for an exemption. Although the complexity and high level of discretion in allocating agricultural land to foreign investors do not seem to have prevented the development of horticulture and floriculture with large foreign involvement, the current system is clearly unsatisfactory and opaque. Further promoting the dynamic horticulture sector would require clear procedures and guidelines on the allocation of Presidential exemptions as a first step, and a complete overhaul of the law as a second step. Significant revisions to land laws are being considered and would be required in order to implement the draft Constitution, which is currently under discussion (see below).

Government land encompasses a large proportion of the prime land suitable for industrial or commercial purposes and is regulated by the Government Lands Act (1915, with subsequent amendments). The Act specifies that government land, whether within townships or agricultural, can be leased for any term not to exceed 99 years. Leases must be sold by public auction, unless the President otherwise orders in any particular case. This Presidential discretionary power was used for decades to run against the spirit of the law, as auctions stopped being used even before independence. A lottery system was used for some time, before the Government switched to a system of administrative allocation of plots.

This administrative system was discretionary and opaque, and opened the door to extensive corruption in the allocation of titles on government land. The coalition Government that acceded to power in 2003 decided to freeze all new allocations of government land until further notice. The Ministry of Land estimates that about 200,000 transactions will have to be scrutinized for possible irregularities or wrongdoing. A Commission of Inquiry was appointed to investigate avenues to address past illegal deals, and is to deliver preliminary conclusions towards the end of 2004. Particularly difficult is the issue regarding the treatment of third parties that acquired leases on government land in good faith from initially fraudulent developers or purchasers of land.

An additional problem for domestic and foreign investors alike is the poor state of land registries, none of which are computerized. This has made it more difficult for buyers to ensure that they are engaged in a legitimate transaction and that there is no claim on the land by a third party. As a result, banks have also been less willing to use land as a collateral in lending to investors.

While nothing in the current Constitution prevents foreigners from holding freehold titles on land, the draft Constitution under consideration proposes to limit foreign ownership of land to 99-year leaseholds at most. Current freeholders would be required to convert their titles to leaseholds. Long leasehold can provide adequate title and indeed it is the principal form of title for all landowners in some countries. However, the modalities of operating separate title forms for nationals and non-nationals could easily cause complications and delays to the detriment of the investment climate. For example, the transfers of land between citizens and foreigners will necessitate change of title form; the ability of foreign-owned banks to take security on land owned by citizens will also require special arrangements. Such issues will need to be carefully addressed in conforming existing land laws to the constitutional change.

6. Environmental Regulations

The Environmental Management and Co-ordination Act (2000) recently introduced comprehensive and modern rules regulating environmental protection. The Act established both the National Environment Council, in charge of policy formulation and of promoting co-operation among public departments, and the National Environment Management Authority (NEMA), which has wide powers to implement the Act. The main features of the Act that are most likely to affect investors are as follows:

- The Act establishes the right of every person to a "clean and healthy" environment. It gives the power to any person (whether immediately affected by environmental damage or not) to apply to the High Court for relief. The High Court itself may order the shutdown of a polluting activity and order restoration and compensation.
- The Act entrenches the principles of polluter-pays and provides for the protection of special areas, including rivers, lakes, wetlands, hilltops and mountains, forests and coastal areas where activities are subject to specific rules.
- Environmental impact assessments are required for a specified range of investments, which include mining, urban development, transportation, agriculture, electricity and many manufacturing industries.

The Act is modern and the principles underlying the environmental impact assessments are sound. It is vital to ensure that the process of granting licences is smooth and well coordinated among public agencies, however. It is encouraging in that respect that the Act specifically empowers the National Environment Council and NEMA to lead and coordinate all agencies dealing with environmental matters.

7. Rule of Law and Administrative Issues

In interviews for this report, investors consistently cited corruption and lack of security as major impediments to FDI. Transparency International ranked Kenya 122nd in its Corruption Perception Index in 2003, within a non-comprehensive list of 133 countries. While this index is based on perception and not on an actual measure of corruption, and while it does not reflect the effects of the recent passage of anti-corruption legislation, it remains a good indication of perceptions that prospective investors will form.

The National Rainbow Coalition (NARC) Government was elected on an anti-corruption platform at the end of 2002. Two significant pieces of legislation were enacted in mid-2003: the Public Officer Ethics Act and the Anti-Corruption and Economic Crimes Act. The former sets out a general code of conduct and ethics for public officers, including standards on professionalism and rules on personal enrichment, conflict of interest and political neutrality. Most significantly, it also requires all public officers to submit an annual declaration of income, assets and liabilities (for him/herself, the spouse and dependent children under 18).

The Anti-Corruption and Economic Crimes Act vests significant powers in the Kenya Anti-Corruption Commission (KACC), which replaced the Anti-Corruption Police Unit. The KACC, which is accountable directly and only to Parliament, is responsible for all investigations regarding acts of corruption or economic crimes. It has wide investigative powers, which include the right to require a person suspected of corruption to submit a list of assets and the way they were acquired, and to call for other specified documents or records. It also has the power to arrest persons and charge them with an offence, and to detain them for the purpose of an investigation.

Corrupt acts and economic crimes committed by public officers are tried by Special Magistrates. Penalties are maximum fines of Sh1 million (\$13,000) and/or imprisonment of up to 10 years. In addition, there are mandatory fines of twice the benefit gained or loss suffered. A convicted public officer is also to be dismissed and disqualified from re-appointment or re-election to public office for 10 years.

The two Acts represent a genuine improvement in the tools available to fight corruption and the KACC appears to be making a sincere attempt to utilize them. The KACC reports having received 3,392 complaints in 2003, of which 303 were taken up for investigation. It believes, however, that it is handicapped by shortage of staff and investigators, inadequate investigative skills, lack of equipment and reluctance by some public officers to release documents to investigators. Bottlenecks at the prosecution stage are also foreseen. Investors report that they have yet to see a tangible reduction in corrupt practices but certainly welcome and support the initiatives that have been taken.

The ability of the courts to deliver commercial justice impartially, promptly and consistently is always a key issue for investors. In Kenya, investors have a poor opinion of the court system on these counts. The World Bank's WBES (2000a) indicates that 74 per cent of investors rated the overall quality of the court system as "slightly bad", "bad" or "very bad", as opposed to "slightly good", "good" or "very good". Similarly, investors indicated dissatisfaction with respect to fairness and impartiality, honesty/absence of corruption, speed, consistency, and enforceability of judgements (table II.5). Kenya also compared rather poorly with its East African Community (EAC) partners and with Egypt and South Africa.

Table II.5 Investors' Perception of Court System, 2000
(Percentage assessing poorly)

	Overall ¹	Fairness ²	Honest ²	Speed ²	Consist. ²	Enforced ²
Kenya	73.8	70.6	82.8	94.9	83.0	70.0
Egypt	7.2	8.1	6.1	30.3	13.1	14.1
S. Africa	27.5	5.1	7.6	84.7	23.9	28.2
U.R of Tanzania	42.3	50.9	65.5	89.3	64.3	50.0
Uganda	42.7	67.3	75.2	89.3	76.5	69.9

¹ Percentage of investors assessing performance as "slightly bad", "bad" or "very bad" as opposed to "slightly good", "good" or "very good".

² Percentage of investors assessing court as fulfilling the criterion "sometimes", "seldom" or "never" as opposed to "frequently", "usually" or "always".
Sample size generally exceeds 100 for all countries.

Source: World Bank (2000a).

Action is being taken to improve the court system. In October 2003, five of the nine Appeal Court judges and 18 of the 36 High Court judges were suspended for alleged corruption. New judges, including many previously working in private practice, have also been appointed for commercial matters.

The judicial system still suffers from a general lack of resources to make rulings on a timely basis and root out corruption, however. Judges are faced with a large number of cases to deal with, and lack sufficient paralegal support staff in a system that is in dire need of computerization. The creation of commercial courts as separate entities in 2001 was a step in the right direction, but it has not had much effect in speeding up the judicial process.

A significant administrative hurdle to making commercial justice and business transactions more efficient lies in the obsolete system used in the Registrar General's office. The Registrar General is in charge of registering companies' details (name, articles of association, statement of nominal capital, etc.) as well as filing their annual returns or accounts. The system is still mostly paper-based, and the sheer lack of physical space and staff prevent the proper filing and classification of documents. While companies are required to file annually, the Registrar's office has little confidence in its own ability to know whether companies have complied with the requirement. It has given up suing companies that it suspects are not complying with the filing requirement for fear of improperly suing companies whose returns were filed but "lost" within the registry.

A group of nine bilateral and five multilateral donors have committed themselves to helping the government fund and implement Governance, Justice, Law and Order Sector (GJLOS) reforms. The programme includes an elaborate set of medium-term targets and a short-term priorities programme (STPP). Seven key areas were identified: (1) ethics, integrity and anti-corruption; (2) democracy, human rights and the rule of law; (3) justice, law and order; (4) public safety and security; (5) constitutional development; (6) quality of legal services provided to the Government and the public; and (7) capacity for effective leadership and management of change. The project will provide wide-ranging support, from technical advice in drafting new legislation to financing and equipping specific departments and offering training to civil servants. Although the STPP was launched soon after the NARC coalition acceded to power, the donor community recently expressed frustrations about the slow progress in combating corruption, one of the major components of the GJLOS project.

8. Competition Regulation

Kenya's competition framework is governed by the Restrictive Trade Practices, Monopolies and Price Control Act (1989, with subsequent amendments). Although the Act is relatively modern, it suffers from some key weaknesses, mostly related to the organizational structure, enforcement power and breadth of mandate of the Monopolies and Prices Commission.

The Commission is not structured as an independent regulatory body, and is instead placed under the direct tutelage of the Minister of Finance. While the Commission is independent in its investigation of competition-related issues, it must rely on ministerial powers to enforce orders on companies found to have breached competition rules. The standard procedure is for the Commission: (1) to investigate cases either following a complaint or of its own will; (2) to inform the party involved of its findings and to seek a response and potentially corrective measures; (3) if a response or corrective steps are not taken, the Commissioner may recommend an order to be enforced by the Minister, after a hearing between the Commission and the party involved has been held; and (4) following the hearing, the Minister may or may not follow the Commission's advice and enforce an order requiring corrective action.

The mandate of the Commission is relatively wide as it is set up to investigate restrictive trade practices, predatory practices, concentration of economic powers, and mergers and acquisitions. Restrictive trade practices are defined broadly as acts that either reduce or eliminate the opportunities for people willing to enter into production at fair market prices, or that reduce or eliminate opportunities for potential buyers at fair market prices. Practices that seek to block entry into production and discrimination vis-à-vis buyers (for production, resale or final consumption) are thus illegal. The Commission has considered close to 150 cases of restrictive trade practices in the past 10 years (1994-2003), the majority of which were resolved without ministerial order.

Predatory trade practices are defined widely as activities that specifically seek to drive competitors out of business, to deter them from offering certain products or to push them to sell assets. In particular, selling below average variable cost and exclusivity contracts with purchasers in exchange for rebates are illegal. In analysing concentration of economic power, the Commission seeks to determine whether the drawbacks of concentration outweigh the potential efficiency gains from integrated production or distribution. The Act defines a threshold of concentration of one third of total market share (regional or national, as the case may be) as a key factor to consider.

Mergers and acquisitions must receive the green light from the Commission and the Minister of Finance in all cases, regardless of sector, size or market share of the companies involved. This puts an unnecessary burden on investors and the Commission, even though it has not created administrative problems for the Commission and delays to investors due to the low level of M&A activity in recent years. The Commission has considered around 200 applications in the past 10 years (1994-2003), and companies seeking M&As usually obtain a response within one month for smaller cases and three months for larger cases. It would be more rational, however, to apply a threshold rule below which M&As do not require approval from the Commission. This would allow the Commission to allocate more of its resources to M&A cases that need genuine and detailed evaluation and to other functions, without affecting consumer interest in any way. While a precise threshold would have to be defined, either on a regional or on a national basis, a post-M&A market share of about one third to 40 per cent is a widely accepted threshold in many countries. The Act itself in fact already defines a one-third market share as a threshold for the Commission to assess undue concentration of market power.

While the mandate of the Commission is relatively wide, it has several key sectoral limitations as article 5 specifically exempts from the provisions of the Act the trade practices that are specifically regulated under other Acts of Parliament. This includes, most significantly, the electricity, telecommunication or insurance sectors, over which the Monopolies and Prices Commission has no oversight, even as far as trade practices

are concerned. Article 5 was invoked recently by the Association of Kenya Insurers to counteract a procedure against cartel behaviour launched by the Commission. The issue was eventually settled through a Consent Agreement, however.

9. Intellectual Property Law

Kenya has a comprehensive legal framework to ensure intellectual property rights protection, which includes the Industrial Property Act (2001), the Trade Marks Act, the Copyright Act (2001), and the Seeds and Plant Varieties Act. It is a signatory to, or member of, the following treaties and organizations:

- The Convention establishing the World Intellectual Property Organization (WIPO);
- The World Trade Organization (WTO), including the agreement on Trade-Related Aspects of Intellectual Property (TRIPs);
- The Patent Cooperation Treaty;
- The Paris Convention for the protection of industrial property;
- The Lusaka Agreement on the creation of the African Regional Industrial Property Organization (ARIPO);
- The Madrid Agreement and Protocol on the international registration of marks.

Copyright protection is granted to literary, artistic, musical and cinematographic works as well as related works. Enforcement is ensured by the Copyright Board, which is part of the Attorney General's office. Penalties for copyright violations can be up to 10 years' imprisonment and/or fines of up to Sh400,000 (\$5,000). Pirated music or software is common, however.

The Kenya Industrial Property Institute (KIPI), established in 2001 under the Industrial Property Act, is the main agency in charge of granting and enforcing property rights and trademarks. Protection can be granted for inventions under a traditional patent system for utility models ("inventions" related to shapes, structures or assemblage of articles), industrial designs and technovations (novel and industrially applicable arrangements of possibly traditional components in an assembly that results in a new solution to a technical problem, i.e. mostly production processes). KIPI is also in charge of registering trademarks and enforcing them. Violations of patents are criminal offences punishable by fines of up to Sh50,000 (\$650) and/or imprisonment of no more than five and no less than three years.

KIPI conducted about 100 outlet raids in 2001-2003 to fight trademark violations. While counterfeit goods were seized, violators were fined rather than jailed, even though some cases are still pending in Court. No precise data are available on the time needed to secure patents or protection for industrial designs. The ratio of patents granted over applications received for the period 1994-2003, however, is about 37 per cent. This can be used as a rough indication that applications are turned over in about three years. The ratio of industrial designs granted over applications received during the same period is about 67 per cent, which roughly translates in a turnover period of around one and a half year. This compares favourably internationally.

The Industrial Property Act offers mostly adequate patent protection in accordance with the TRIPS agreement, even though a few provisions may be a matter of concern to investors. Patents can be obtained for both products and processes and are valid for a period of 20 years, subject to payment of an annual fee. Rights and obligations of patent holders are fairly standard, and include exclusive rights on the making, importing and selling of products, as well the ability to conclude licence contracts.

Like TRIPS Articles 2 and 3, the Industrial Property Act bans patents for plant varieties and for inventions that are detrimental to public order, morality, public health or the environment. The Act goes beyond the TRIPS provisions, however, in that Article 21 also rules out as a patentable invention the "uses of any molecules or other substance whatsoever used for the prevention or treatment of any disease which the Minister responsible for matters relating to health may designate as a serious health hazard or as a life threatening disease". This goes

beyond the provisions of TRIPS Articles 30 and 31 and their recently agreed interpretation with respect to the provision of generic pharmaceutical products (box II.2) in that patenting of molecules itself can be banned by Ministerial decision.

Article 80 of the Industrial Property Act has provisions similar to those of Articles 30 and 31 of the TRIPS agreement that allow a patented invention to be exploited by a Ministry or another institution designated by the Minister to exploit the patent, subject to a prior attempt to seek a licence from the patent holder and payment of adequate compensation. Two situations make this possible. The first is related to public interest (national security, health, environmental conservation) and is similar in intent to the provision allowed under the TRIPS agreement. The second requires that the director of KIPi determine that “the manner of exploitation of an invention by the owner of the patent or his licensee is not competitive,” similar to the provision of TRIPS Article 31(k).

While Article 80 is somewhat more restrictive in nature than the TRIPS provisions in that it allows compulsory licensing only in the two circumstances listed above (no specific circumstances are provided for in the TRIPS agreement), it also specifies that no compensation shall be paid to the holder of the patent when “any molecule or substance” is subject to compulsory licensing for manufacturing, supply or import. This effectively allows the making of generic drugs in Kenya without compensation to the holder of the patent, which appears to be contrary to TRIPS regulations.

Box II.2 TRIPS Agreement and Compulsory Licensing

Article 30 of the TRIPS Agreement allow WTO member States to “provide limited exceptions to the exclusive rights conferred by a patent, provided that such exceptions do not unreasonably conflict with a normal exploitation of the patent and do not unreasonably prejudice the legitimate interests of a patent owner”. Article 31 further allows member states to use patents without the authorization of the right holder (either directly or through a third party) under a set of conditions, including: (1) prior efforts to obtain authorization from the patent holder on reasonable commercial terms; (2) production of the patented good for supply to the domestic market; (3) adequate payment of remuneration to the patent holder; and (4) non-exclusive use of the patent. Article 31 also makes provisions (1) and (2) non-compulsory when the “unauthorized” use of the patent by third parties is granted to remedy anti-competitive practices by the patent holder.

While Articles 30 and 31 apply to any type of patent, the debate about their application to pharmaceutical products has been particularly acute in recent years. The Doha Declaration (November 2001) and the related decision of the WTO General Council (August 2003) on the interpretation of its paragraph 6 clarify the conditions under which compulsory licences can be used for the making and trading of pharmaceutical products. In essence, Articles 30 and 31 must be interpreted as conferring on member States the right to apply compulsory licences for the making and trading of generic products, so as to make access to medicine more affordable in developing countries. The WTO reiterated, however, that re-export of imported generic medicines should be prevented, and that adequate remuneration (pursuant to TRIPS Article 31(h)) should be paid to the patent holder.

Source: TRIPS Agreement and WTO declarations.

10. Corporate Governance and Accounting Standards

The Companies Act (1962, with subsequent amendments) pre-dates independence and has not been amended sufficiently over the years to reflect evolving business conditions and practices. While it rests on fundamentally

sound principles adopted from English law, it imposes burdensome practices in setting up companies and lacks flexibility, in particular for small businesses. According to the World Bank's "Doing Business" survey, it takes an average of 47 days to go through 12 procedures at a cost of \$220 to set up a company. This excludes securing business licences, however, and is somewhat higher than set-up times in Egypt, South Africa, the United Republic of Tanzania or Uganda (table II. 6). Rules on capital structure and capital maintenance are rather strict and based on the concepts of nominal capital and par values, with the aim of protecting both creditors and shareholders.

The Act also imposes relatively strict rules regarding company seal, registration of the details of the directors, and procedures for company meetings. It also retains the principle of *ultra vires*, which prevents companies from entering into transactions that do not fall within the scope of their memorandum of association. While this rule was aimed at protecting minority shareholders, it has long been reformed in most common law countries to allow greater flexibility in management and reduce the complexity of memoranda of association. It is also excessively rigid for small and family-owned companies, which represent a significant share of the business sector.

Table II.6 Companies' Set-Up Times and Cost, 2004

	Kenya	Egypt	South Africa	U. R. of Tanzania	Uganda
Set-up time (days)	47	43	38	35	36
Procedures (number)	12	13	9	13	17
Cost (dollars)	223	858	358	514	306

Source: World Bank, Doing Business, 2004.

Audited accounts must be filed annually with the Registrar's Office and must "give a true and fair view of the state of affairs of the company as at the end of its financial year". International accounting standards are used by many of the larger companies, which also tend to have their accounts audited by major international firms, many of which have their regional headquarters in Nairobi. Smaller firms, however, do not adhere to the same standards, and may not file annual returns at all as the Registrar's office lacks the capacity to monitor and enforce filing requirements (section 7).

II. Selected Sectoral Regulations

Investor surveys consistently highlight the poor quality and high cost of backbone services, including telecommunications, electricity and transport, as a major weakness of the investment framework and an impediment to their international competitiveness. Improving the quality and reducing the cost of backbone services must be a top priority both for FDI attraction and for higher economic growth. Given public finance constraints and for efficiency purposes, a much higher degree of private sector participation in backbone services is necessary. In several sectors the regulatory framework has been modernized to enable competitive private services. But the opportunities for attracting private investment, including FDI, have not been taken and high-cost public monopolies prevail.

a. Telecommunications

Kenya is poorly served in fixed access telecommunications. Teledensity is low, geographical coverage is poor, calls are expensive and waiting times for connection are excessive despite adequate capacity in switching and lines. Broadband Internet access is limited and expensive, with a 1,024kbps (downstream) ADSL connection costing around \$500 per month.²³ These problems have to some extent been relieved by the rapid growth in mobile phone use but, overall, inadequate telecommunications service and high costs are major constraints on business competitiveness.

²³ Similar services cost about \$100 per month in South Africa, \$30 in the United States and \$20 in France.

State-owned Telkom Kenya remains the monopoly provider of fixed access, even though its exclusivity period expired in June 2004. There have been some important corporate and regulatory changes introduced in the last few years. A modern regulatory regime was established in 1998 by the Kenya Telecommunications Act, which set up an industry independent regulator, the Communications Commission of Kenya (CCK). Telkom Kenya was created in 1999 as a separate legal entity from the previous postal and telecommunications statutory body and scheduled for privatization, but this has not occurred. CCK has fined Telkom Kenya for not meeting performance requirements but the company is apparently unable to pay the fines. CCK has opted to introduce competition immediately and has tendered a second national operator (SNO) licence.²⁴

The SNO licence conditions are refreshingly pro-competitive:

- Introduction of a second operator will not await the privatization of Telkom Kenya (now planned for 2005).
- The SNO (and by implication Telkom Kenya) will not be guaranteed a period of exclusivity. CCK will retain the right to issue further fixed access licences should the incumbents not meet performance obligations or not establish vigorous competition.
- Price and other conditions for fixed access services will continue to be regulated until CCK is satisfied that competitive conditions exist.
- The SNO will offer local, long-distance and international services and will be able to negotiate interconnection to the trunk system and the "last mile" lines owned by Telkom Kenya.

There are two mobile operators (both with foreign strategic investors) and a third licence will be issued shortly.

A liberal and pro-competitive approach is being taken in relation to other Internet and telecommunications services. However, independent international gateway operators will not be permitted except on a case-by-case basis to support private networks. If the latter policy is implemented flexibly it will assist export companies (including those in the EPZAs) requiring first-rate voice and data international services and also the fledgling business process outsourcing industry. For example, Old Mutual is planning to move its insurance and asset management back-office functions to its Kenyan affiliate and has obtained a private international gateway licence.

The current telecommunications strategy was introduced in 2001 and the Government is updating it. Its goals are to enhance Kenya's position as a regional business hub, to expand telecommunications coverage throughout Kenya and to enhance Kenyan participation in telecoms ownership. Two specific policies bear on these objectives:

- Access levies to cross-subsidize rural services;
- Foreign ownership in all telecom services will be a maximum of 70 per cent.

Given the difficulty that many countries have faced in securing participation of major players as SNO and in fostering competition and a high quality of services through the SNO approach, a more radical approach could be considered in order to maximize the competitiveness of the system, availability and quality of services for users (box II.3).

Such an alternative maxi-competitive approach would not depend on finding a second national operator (SNO) to provide competition to the incumbent within a universal service framework. South Africa has had great difficulty in implementing the SNO model. It has been difficult to find well-capitalized major players willing to compete head to head across an entire country with a well-established incumbent. Among African countries, Nigeria probably comes closest to this alternative approach.

²⁴ The current tender has been halted and the SNO licence will be re-tendered to ensure greater transparency.

Box II.3 A Maxi-Competitive Approach for Telecommunications

An alternative model to the classic SNO approach would have the following elements:

- Award metro licences for fixed access voice, data and Internet services in urban areas. Licensees could choose to build new wire networks, provide wireless loop services or negotiate interconnection with Telkom Kenya. Although interconnection between licensees should optimally be on a negotiated competitive basis, the regulator should establish *ex-ante* regulatory prescriptions on interconnectivity arrangements in order to avoid anti-competitive behaviours, particularly by the current monopoly holder of the wire network, Telkom Kenya, which is unlikely to have strong incentives to engage in interconnectivity arrangements.
- Improve rural telephony services by awarding rural telephony licences (fixed line and mobile) with subsidies provided to support services that are not fully commercial. These licensees would most likely construct microwave connections to other domestic operators or negotiate terms for Telkom Kenya to provide the service and further interconnections.
- Award international gateway licences, enabling the licensees to provide international services on a competitive basis to customers of the other operators (including Telkom, metro and rural telephony licence holders), under a regulated interconnectivity set-up. The metro and rural licensees would also be eligible to apply for international gateway licences.
- Permit mobile operators to have their own international gateways, or to negotiate interconnection to Telkom Kenya or independent international gateway operators at their choosing, under a regulated interconnectivity set-up.

This model would inject maximum competition into the system with enforcement operating as a reserve power in relation to infrastructure access and interconnection charges. In particular:

- Quality and cost for business users would benefit from strong competition in voice, data and Internet services among the competing local carriers and among the competing international carriers. Broadband access would respond to customer demand.
- Mobile services (which are growing very fast for business and personal use) would be free to have dedicated international access or to contract independents on a competitive basis. Mobile providers would also face beneficial competition from a new wave of fixed access providers.

Source: UNCTAD.

b. Electricity

The electricity sector was restructured and partly liberalized amid power shortages in the mid-1990s. Generation, transmission and distribution were unbundled under the Electric Power Act (1998), which also established the Electricity Regulatory Board (ERB) as the regulatory body. The unbundling led to the creation of the Kenya Electricity Generation Company (Kengen), a wholly government-owned generation company, and of Kenya Power and Lighting Company (KPLC), which has a nation-wide monopoly over transmission and distribution. Although it is listed on the Nairobi Stock Exchange, the Government still owns 40 per cent of KPLC, with another 11 per cent owned by the National Social Security Fund.

In order to address power shortages, the Government also awarded four generation contracts to Independent Power Producers (IPPs) under Power Purchase Agreements (PPAs) with KPLC. IPPs have a production capacity of 222 megawatts (MW), about 20 per cent of the total, with Kengen accounting for the other 80 per cent. Three of the IPPs operate a thermal station, and the fourth operates a geothermal station with a capacity of 48MW. In contrast, Kengen's effective capacity of 860MW is 75 per cent hydro, 20 per cent thermal and 5 per cent geothermal.

The pressing need to increase generating capacity in the late 1990s and the difficult and uncertain operating environment (including poor macroeconomic performance, uncertainty about the efficiency of the newly created regulator and the weak financial position of KPLC, the single power purchaser) pushed investors to demand high risk premiums from the Government, and to obtain a return on investment in periods as short as seven years in two cases. As a result, KPLC's purchase prices with the IPPs, which are based on the contractual terms of the PPAs and generally include a take-or-pay clause, vary between about $\text{KSh } 10$ per kilowatt hour (KWh) to around $\text{KSh } 25/\text{KWh}$. This compares with around $\text{KSh } 5/\text{KWh}$ for power purchased from Kengen. Contractual terms with certain IPPs are now open to renegotiations, and KPLC reports ongoing negotiations with three of its four IPPs with a view to reducing bulk power prices.

Although the Electric Power Act allows for the separation of transmission and distribution and for competition in distribution, KPLC retains the monopoly over both functions throughout the country. The Government does not plan to open up distribution to competition at the moment, as its strategy focuses first on restructuring and improving the operating conditions of KPLC, partly with World Bank funding. KPLC has been making financial losses for the past four years, and has a poor efficiency record. Power losses as a percentage of net generation, in particular, have averaged about 20 per cent in the past five years. The company also reports 11,000 power outages per month in its fiscal year 2002/03 as a result of insufficient maintenance of its distribution network.

While the distribution and transmission sectors will remain a regulated public monopoly for the foreseeable future, the Government plans to sell around 30 per cent of the capital of Kengen through an Initial Public Offering (IPO) on the Nairobi Stock Exchange. The Government's plans to develop geothermal capacity, which it estimates at around 2000MW, are also likely to further involve private investors. Restructuring efforts at KPLC, in turn, should focus on separating the transmission and distribution activities with a view to allowing more transparent accounting of revenue and expenses, and segregated performance benchmarking.

c. Ports and Airports

Kenya has one major and eight minor seaports, all managed by the Kenya Ports Authority (KPA), a parastatal established under the Act of the same name (1978, with subsequent amendments). Mombasa is the main port of entry and serves neighbouring countries, including Uganda, Rwanda, Burundi and parts of Sudan and the United Republic of Tanzania (table II.7). Competition from Dar es Salaam as a regional hub is increasing, however, particularly for shipments to and from Rwanda and Burundi.

Table II.7 Traffic Handled at Port of Mombasa
(Thousand dead weight tons)

	1999	2000	2001	2002	2003
Total	8 045	8 931	10 297	11 224	11 326
Imports	6 200	7 209	8 299	7 844	9 258
Exports	1 845	1 722	1 998	2 380	2 068
Transit (exports & imports)					
Uganda	1 013	1 115	1 670	1 710	1 894
United Republic of Tanzania	63	93	146	157	182
Rwanda	109	72	109	81	176
Sudan	46	45	67	93	75
Dem. Rep. of the Congo	52	76	69	100	72
Others	26	53	56	74	53

Source: Kenya Ports Authority.

KPA's powers are wide-ranging, and it currently manages and operates most functions in the port of Mombasa. The Act allows the KPA to engage the private sector in the provision of services or facilities that it would normally perform or provide. Maersk Sealand of Denmark, for example, offers container storage facilities as well as trucking services, and KPA licensed four private stevedoring companies. KPA is also required by the Act to "conduct its business according to commercial principles" and to ensure that its net operating income provides a return on assets as specified by the Minister of Transport. All borrowing by KPA must have the approval of the Minister of Finance, however, and major alterations to tariffs, rates, fares or other charges must be approved by the Minister of Transport in consultation with the Minister of Finance.

The Government has been considering changes to the KPA Act to allow greater private sector participation in the port of Mombasa since 2000, but with little actual progress so far. The reforms would turn KPA into a landlord port authority, as it would retain ownership of the port infrastructure and superstructure and continue its regulatory role. User services, in contrast, would be provided by private operators in a competitive environment, which could greatly enhance the quality of services while at the same time lightening the financial burden of building and operating infrastructure on government finances. The draft privatization programme states that conventional cargo would be privatized, the container terminal would be corporatized, dockyard facilities would be concessioned and a tender issued for a second container terminal under a build-operate-transfer arrangement.

The transformation of KPA into a landlord authority requires legislative changes, which means that progress in privatizing assets is likely to be slow. In the meantime, however, the authorities have succeeded in improving the efficiency of the port in the past few years. The average number of waiting days per ship fell from 3.6 in 2000 to 1.6 in 2003, even though traffic continued to increase. Port services were also made available seven days a week, with longer opening hours daily. Nevertheless, the port is not moving to cope with the needs of fast moving international companies. For example, garments producers report that three days' advance notice is required in order to secure export handling. Investors also continued to express concerns about delays in clearing customs and the integrity of the process. Although some improvement may have happened since then, 54 per cent of investors surveyed in the World Bank WBES survey in 2000 rated the overall quality of the customs services as "very bad", "bad" or "slightly bad". This compares with only 36 per cent for the United Republic of Tanzania, the main competitor for deep-sea port services. A Transparency International survey in 2001 also rated the likelihood of encountering bribery in dealings with the KPA at 75 per cent.

Jomo Kenyatta Airport in Nairobi is East Africa's major hub, partly as a result of the very successful privatization of Kenya Airways in 1996, which led to a strategic partnership with KLM of the Netherlands. The privatization of Kenya Airways has been an undisputed success, as the company quickly returned to profit while vastly improving the quality of services and contributing to the development of Nairobi as a regional platform. Kenya Airways currently operates direct passenger flights to Amsterdam, London, Bangkok, Dubai, Hong Kong (China) and Mumbai, in addition to 21 destinations in Africa. It also has cargo services to similar destinations, and provides ground services to over 25 companies, from baggage handling to cargo warehousing and aircraft maintenance. More than a dozen major European and Asian airlines also operate direct flights to Nairobi.

The Government updated the institutional framework in 2002 with the amendment of the Civil Aviation Act and the creation of the Civil Aviation Authority (CAA), which is in charge of the safety and technical regulation of civil aviation, the provision of air navigation services and the licensing of air services. The running of Kenya's airports, in turn, is in the hands of the parastatal Kenya Airports Authority. As mentioned earlier, however, the private sector is allowed to provide services within Kenya's airports.

Jomo Kenyatta Airport currently is a clear leader as a passenger and cargo hub for East Africa. Its position could be further developed and strengthened, however, with more private sector involvement in providing facilities and services. Passenger traffic exceeded 3 million people in 2002, a 30 per cent increase from three years earlier (table II.8). Cargo handling, in turn, reached 169,000 tons in 2002, a 45 per cent increase from three

years earlier. This is partly a reflection of the sharp rise in shipments of horticulture products to Europe, which would not have been possible without frequent direct air links and handling facilities, including refrigerated storage and a dedicated cargo terminal.

Table II.8 Passenger and Cargo Traffic at Jomo Kenyatta Airport, 1998-2002
(Thousand passengers or metric tons)

	1998	1999	2000	2001	2002
Passengers (incl. transit)	2 350	2 668	2 945	2 968	3 057
Arrivals	1 087	1 248	1 376	1 383	1 458
Departures	1 051	1 205	1 358	1 399	1 472
Cargo	117 674	126 621	140 643	139 612	169 009
Loaded	77 226	94 703	101 997	99 159	123 494
(United Kingdom)	(17 611)	(20 157)	(25 334)	(23 606)	(27 813)
(Continental Europe)	(31 356)	(38 600)	(43 620)	(42 714)	(32 472)
(Middle East)	(16 530)	(21 391)	(14 740)	(16 194)	(23 842)
(Africa)	(8 927)	(10 941)	(12 607)	(12 348)	(37 296)
Unloaded	40 449	31 917	38 646	40 453	45 515

Source: Central Bureau of Statistics, Statistical Abstract, 2003.

Landing fees are relatively high at Jomo Kenyatta Airport, although they are similar to those imposed in other airports in the region. The relative cost (setting Jomo Kenyatta at 100) of operating a Boeing 747-200 (including aircraft, crew, maintenance, fuel, landing and handling costs) to Paris or London is 11 per cent and 4 per cent lower from Addis Ababa and Entebbe, respectively, than from Nairobi, and 8 per cent higher from Dar Es Salaam (table II.9). The proximity to Europe also implies that airfreight costs to Europe are about 60 per cent lower from Casablanca and 40 per cent lower from Cairo. This has obvious competitiveness implications for the horticulture industry, which is dependent on air cargo and requires that particular care be given to maximizing the competitiveness of airport services.

Table II.9 Relative Airfreight Costs¹ and (Distances)²
(Jomo Kenyatta to destination = 100)

Origin	Destination			
	Paris	London	Chicago	Hong Kong (China)
Nairobi	100.0 (100.0)	100.0 (100.0)	100.0 (100.0)	100.0 (100.0)
Abidjan	79.5 (75.2)	79.3 (75.5)	73.4 (70.5)	138.6 (144.2)
Addis Ababa	88.2 (85.9)	88.7 (86.4)	94.9 (94.4)	93.8 (92.9)
Bogota	127.5 (133.1)	120.0 (124.6)	39.9 (33.8)	181.3 (192.9)
Cairo	57.9 (49.5)	59.4 (51.5)	78.7 (76.5)	93.8 (92.9)
Casablanca	41.5 (28.0)	41.7 (29.5)	57.5 (53.3)	125.3 (127.6)
Dar Es Salaam	108.5 (110.3)	108.2 (109.8)	104.4 (104.9)	100.2 (100.0)
Entebbe	95.5 (94.3)	95.8 (94.7)	96.8 (96.4)	104.0 (104.4)
Johannesburg	128.7 (134.6)	127.5 (132.9)	107.8 (108.5)	119.4 (122.3)
Shanghai	135.1 (142.9)	129.2 (134.9)	89.0 (88.2)	25.5 (14.0)

¹ Cost of operating a Boeing 747-200, including aircraft, crew, maintenance, insurance, fuel, landing and handling costs.

² Great circle distance.

Source: Aerocom aviation software and US Department of Agriculture (distances).

The competitive position of Jomo Kenyatta Airport also ought to be further reinforced with continued efforts to upgrade facilities, including through private sector involvement. At the moment, there are no direct flights to the United States, which is an impediment to taking advantage of potential business opportunities

generated by the AGOA trade agreement. The US Federal Aviation Administration (FAA) has not assessed whether the Kenya CAA complies with the International Civil Aviation Organization (ICAO) standards for the licensing and oversight of air carriers. FAA assessment and approval, however, would be necessary if Kenya Airways wanted to start direct flights to the United States. Regardless of Kenya Airways current plans, the CAA should consider seeking approval from the FAA so that direct flights could become a possibility as soon as the need arises.

d. Mining

The mining sector is small and underdeveloped, representing only about a quarter of a per cent of GDP. Production is currently dominated by non-metallic minerals, in particular soda ash, fluorspar and diatomite, in addition to small quantities of gold and gemstones. While basic geological surveys (including collection of geophysical and geochemical data and aerial maps) have been carried out for about 90 per cent of the territory, there has been little exploration activity so far, in large part as a result of an outdated mining legislation that does not provide internationally competitive exploration rights and fiscal arrangements for development that investors would require in order to invest in what remain relatively untested and uncertain waters.

Mining operations are regulated by the Mining Act, which was first enacted in 1940, and subsequently received less than comprehensive amendments. In some important respects, the mining regime is not suited to large-scale modern mining investment:

- Exclusive prospecting rights are renewable annually and have a maximum term of five years. Longer renewal periods and much longer overall terms are needed for investors to undertake the extensive exploration required to identify and prove large-scale commercial deposits, let alone conduct the detailed technical and financial assessments needed to establish a viable and bankable project. The duration of mining leases –up to 21 years and with right of renewal– is acceptable.
- The rights to mine upon finding a commercial deposit and submitting an acceptable development proposal are not firm. Procedures to move from exploration to development and production in the event of discovery are not clearly specified in the law, which gives a large amount of discretion to the Government and provides little comfort to investors.
- Royalties are negotiated on a case-by-case basis. While rates are within those commonly accepted by the Commonwealth countries, major investors would prefer to operate with a standard schedule of royalty rates that are known in advance of contemplating significant expenditure on exploration. More generally, the fiscal regime is not fully standardized and should be more finely calibrated to adequate fiscal return to the State while ensuring that it accommodates investors' needs for internationally competitive arrangements.

While geological surveys make the Government confident that the country has significant exploitable base metals deposits, little exploration activity is likely until the legal framework has been modernized and the fiscal regime made internationally competitive. The Government is taking the initiative. It commissioned a comprehensive review of the mining legislation and fiscal regime by the Commonwealth Secretariat. The report concludes that the mining regime is excessively discretionary. This view is corroborated by Kenya's premier new project, the Kwale venture, which has taken a very long time to settle development terms, despite not being large or technically complex by world standards (box II.4). The report was received in 2004, and the Government has started to work on a new Mining Act.

Box II.4 Tiomin Resources Kwale Project

Tiomin Resources Inc. of Canada was granted an exploration licence for the Kwale project in 1997. It completed the baseline study in 1999 and initiated work on the environmental impact assessment, which was finalized in 2000. The enactment of the Environmental Management and Co-ordination Act in 2000 required additional work on the assessment, and issues arose about the resettlement of residents affected by the mining project. The Government also attempted to gain equity participation in the project, which Tiomin Resources refused.

In February 2004, the Government agreed that the projects could go ahead without its equity participation. A month later, Tiomin Resources acquired land for a ship loading facility at Mombasa port. The issue of resettlement of the local population was settled in June 2004, with each household receiving five acres of farmland and one acre of residential land in the defunct Ramisi sugarcane plantation, in addition to compensation for lost crops, trees and buildings. A 21-year mining licence for rutile and associated minerals was formally approved and signed by the Government in early July 2004. A fiscal agreement was signed in February 2005, granting Tiomin Resources a 50 per cent reduction in the corporate tax rate for 10 years from the start of commercial production, and giving a 2.5 per cent gross revenue royalty to the Government.

Tiomin Resources has invested about C\$25 million (\$20 million) since 1997 in exploration, engineering, feasibility and environmental studies on the Kwale and three other projects in the same area. The expected development cost is \$120 million to generate an operating cash flow of around \$35 million per year in the first six years, based on output of rutile, zircon and ilmenite. The project should create about 350 permanent jobs directly, and close to 1,000 jobs during the construction phase. Tiomin Resources is also continuing work on mining projects for the same minerals in Kilifi and Mambui.

Source: Government interviews and Tiomin Resources website.

12. Privatization

Kenya launched a Parastatal Reform Project in 1994, which identified 207 public enterprises in non-strategic commercially-oriented enterprises earmarked for privatization. While many of these have been sold, the list did not include the larger public enterprises operating in telecommunications, transport or banking. The programme also proceeded without a formal privatization law.

More recently, the Government has drawn up a preliminary list of 33 public enterprises earmarked for partial or full sale through a renewed privatization programme with IMF and World Bank support. The list encompasses much more significant companies than in the previous programme, and includes four banks, KPLC, Kengen, the Kenya Ports Authority, Telkom Kenya and the Kenya Railways Corporation. The sale of assets is also to take place under the umbrella of a formal Privatization Bill, which is now under discussion in Parliament.

The draft Privatization Bill limits itself to setting up the broad framework under which public assets are to be sold. The main features of the Bill are:

- The Bill lists the desired benefits of privatization, which include improvement in infrastructure, lower demand on government resources, the generation of revenue and increased economic efficiency.
- Five methods of sales are authorized: (1) public offering of shares; (2) concessions, leases or management contracts; (3) negotiated sales; (4) sale of assets, including liquidation; and (5) any other method approved by the Cabinet for specific transactions.

- It establishes a Privatization Commission in charge of the implementation of the programme. It is required to conduct sales in an open and competitive way that ensures that the price represents fair value.
- Both citizens and foreigners are allowed to participate in the programme, even though the Minister of Finance may, for a specific transaction, limit participation to Kenyans or require a minimum level of participation by Kenyans.

Regulations setting the precise framework under which sales are to be conducted are yet to be drafted. Although asset sales have proceeded in the past without a formal privatization law and accompanying regulations, it is crucial that these be enacted as rapidly as possible so as to allow the privatization programme to proceed as planned and transparently.

13. Trade Agreements

Kenya is a founding member of WTO, and had previously been a member of GATT since 1964. It is also member of two regional trade blocs – the Common Market for Eastern and Southern Africa (COMESA), and the East African Community (EAC) – which both have ambitious agendas (only partially realized so far) of regional economic cooperation and integration beyond the creation of free-trade areas. Kenya also benefits from preferential access to the European Union (EU) market through the Cotonou Agreement and to the US market through the African Growth and Opportunity Act (AGOA).

Although the COMESA Treaty set an ambitious agenda of economic and social integration modelled on the European Union, it is at the moment limited to a preferential trade area, whose member countries include both significant markets and potential competitors for Kenya: Egypt, Ethiopia, Mauritius and Sudan, among a total of 20 member States. While the medium-term aim is to establish a customs union with free trade in goods and services among member States, progress so far on a COMESA-wide basis has been limited to the lowering of tariffs on goods, without full elimination. A subset of 11 countries,²⁵ including Kenya, nevertheless agreed to proceed faster with the elimination of tariffs on goods at the end of 2000, subject to rules of origin.

Kenya, the United Republic of Tanzania and Uganda signed the protocol on the establishment of the EAC customs union for trade in goods in March 2004. Common external tariffs were established on 1 January 2005, with a minimum rate of 0 per cent, a middle rate of 10 per cent and a maximum rate of 25 per cent. Free-trade in goods among the three member countries, however, will be phased in only through a rather convoluted and administratively heavy triangular system in a period of five years.

Goods traded between the United Republic of Tanzania and Uganda and goods exported from the United Republic of Tanzania and Uganda to Kenya will be exempt from duties at once. Duties on certain categories of goods (manufactured goods) exported from Kenya to the United Republic of Tanzania and Uganda, however, will be phased out in a period of five years, following a differentiated schedule and set of tariffs for the two countries. Given the free movement of goods between the United Republic of Tanzania and Uganda, this differentiated approach in phasing out tariffs on Kenyan exports to the two countries will require a high administrative burden to enforce rules of origin. This is likely to outweigh the benefits for the community of providing different levels of temporary protection to the manufacturing sectors in the United Republic of Tanzania and Uganda.

Kenya's overlapping trade agreements within COMESA, COMESA's Eleven and EAC are presented in figure II.2, which also shows the varying degrees of liberalization in trade in goods. Clearly, participation in the free trade agreement within the COMESA Eleven subset has generated progress in liberalizing the trade regime and increasing competition in the manufacturing sector. In particular, the absence of tariffs on trade in goods with Egypt has the potential to generate enhanced competition given Egypt's emerging manufacturing sector. The

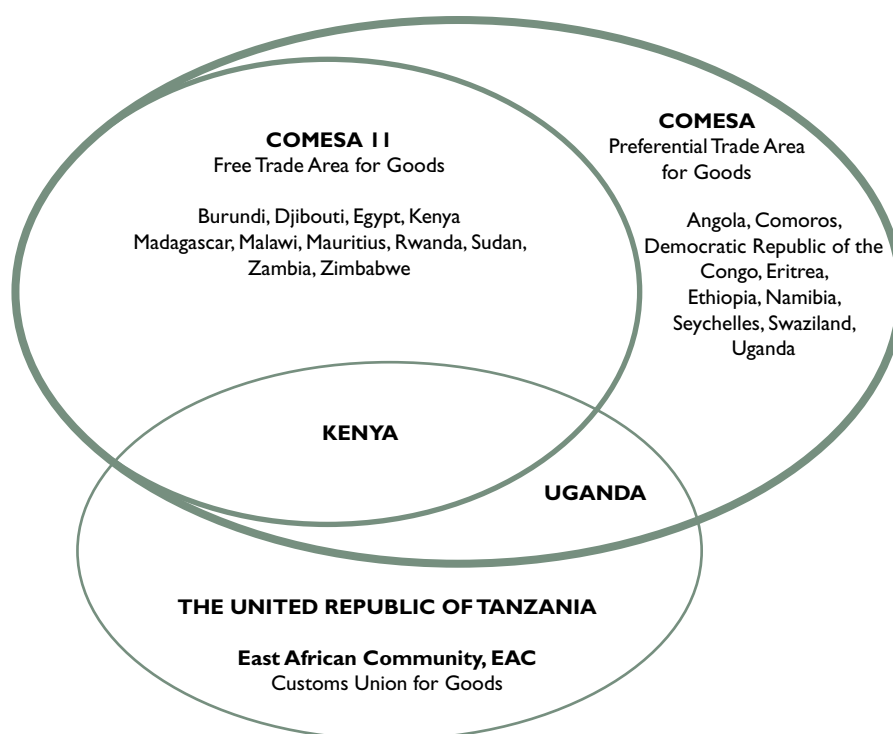
²⁵ Burundi, Djibouti, Egypt, Kenya, Madagascar, Malawi, Mauritius, Rwanda, Sudan, Zambia and Zimbabwe.

main driver of tariff rates in the near future, however, will be the implementation of the EAC customs union. This will force Kenya to lower many of its tariffs previously applied and should generate a more liberal regime. The United Republic of Tanzania and Uganda have had slightly more liberal trade regimes as illustrated by lower average MFN tariffs. This may be a positive factor pushing towards a more liberal regime in the future, as the customs union will now require coordination between the three countries deciding on their MFN tariffs.

Kenya is eligible for preferential access to the US market under AGOA, which allows duty-free treatment of about 6,400 tariff line items, 1,800 more than under the standard Generalized System of Preferences (GSP). In addition, AGOA-eligible countries are not subject to the “competitive need limitation” clause, which terminates duty-free GSP treatment for any given good once certain thresholds of imports (either as absolute amounts or as a share of total US imports) are reached. These preferences were initially granted until September 2008, and have been extended until September 2015 under the second AGOA amendment in July 2004.

Apparel exports are subject to special provisions under AGOA. Six types of apparel are allowed to enter the United States duty-free and quota-free. These include apparel assembled in AGOA countries from US fabrics, apparel assembled in AGOA countries from a mix of US and AGOA country fabrics, apparel knit from certain wools (regardless of country of origin of the wool), and hand-loomed folklore articles. Other apparel are allowed duty-free access only up to a certain cap, calculated as a percentage of total US imports of these apparel (measured in square metres equivalent).

Figure II.2 Trade Agreements with African Neighbours, COMESA and EAC



The cap is allocated on an aggregate basis to all AGOA countries, and on a first-come first-served basis. It was initially set on an increasing scale from 1.5 per cent in 2000/01 to 3.5 per cent in 2007/08. The percentages were doubled in the first AGOA amendment (August 2002), however, to culminate at 7 per cent in 2007/08. The cap applies to apparel assembled in AGOA countries from fabric wholly formed in the same countries from either their own or US yarn. Countries with an annual per-capita income level below \$1,500 (including Kenya) are also allowed to export duty-free apparel made from third-countries' fabrics (i.e. non-AGOA and non-US)

but wholly assembled locally. Such exports count towards the total cap, however, and were initially allowed only until September 2004. The second AGOA amendment signed in July 2004 extended this treatment of third-country fabric but AGOA-assembled apparel to September 2007, still subject to the cap.

Although it benefits from preferential access to the EU market, Kenya is not eligible for the Everything But Arms (EBA) initiative, which grants duty-free and quota-free access to EU imports of all products originating from LDCs, except for arms and munitions (and bananas, sugar and rice during a transition period). As an ACP country and signatory to the Cotonou Convention, however, Kenya does qualify for duty-free access for most goods, subject to rules of origin and with some restrictions imposed on four agricultural products (beef, sugar, bananas and rum).

D. Assessment

The Investment Promotion Act enacted at the end of 2004 introduced a critical barrier to FDI that should be lifted as a matter of urgency, it being ensured at the same time that the Government has appropriate tools at its disposal to address its legitimate concerns about national private sector development. Beyond amending the Investment Promotion Act, and although many of the laws that determine the investment framework would benefit from being modernized, the weaknesses that must be addressed most urgently relate more to matters of implementation. Significant modernization work can and should be done on the laws themselves, but this is likely to be a lengthy process. In the meantime, priority should be given to make the current body of law work better, which is a challenge within reach as the principles laid out in the legal system are in many cases sound.

I. Amend the Investment Promotion Act

The imposition of compulsory Investment Certificates, together with a minimum capital requirement of \$500,000, creates a considerable legal barrier to and administrative burden for FDI, which go against the Government's own objective of promoting and facilitating domestic and foreign investment. It also transforms Kenya into one of the countries with the more restrictive conditions for FDI entry in Africa and is likely to defeat important policy initiatives (including those recommended in chapter III) to attract FDI, particularly in the services sector where Kenya has the potential to attract small-scale and knowledge-intensive investments and become a regional hub.

The general restriction of the Act sends the wrong signal to foreign investors, namely that Kenya is turning away FDI at a time when many countries in Africa and elsewhere in the world are adopting more liberal entry regimes and/or adopting more precisely targeted policies to regulate FDI entry. Ethiopia recently lowered its minimum capital requirement for FDI from \$500,000 to \$100,000 (\$50,000 in some services sectors). The United Republic of Tanzania does not impose minimum capital requirements for FDI entry in general, but makes special incentives conditional upon holding an investment licence and investing a minimum of \$300,000. Uganda does not require foreign investors to invest minimum amounts but offers the facilitation support of its Investment Authority when investment exceeds \$100,000 (soon to be revised to \$25,000 for both national and foreign investors).

Additionally, the minimum capital requirement will not effectively grant protection to national investors in sensitive areas and maximize the benefits of FDI. The size of investment is by no means an indicator of "seriousness" and benefits to the economy, and large foreign investments may crowd out small national investors as much as more modest foreign investments.²⁶

The Government recently recognized these shortcomings and proposed amendments to the Investment Promotion Act for adoption by Parliament on 8 June 2005. The amendments would make investment certificates

²⁶ As mentioned in chapter II, Homegrown started up with an initial investment well below \$500,000 and yet generated large benefits to Kenya. In contrast, large foreign investments in the retail sector could bring stiff competition to small shopkeepers.

optional for all investors, hence removing the barrier to FDI entry introduced previously. Special incentives would remain conditional upon holding a certificate, although the minimum capital requirement to qualify for one would be lowered to \$100,000 for foreign investors and Sh1,000,000 (\$13,000) for national investors.

If adopted by Parliament, these amendments would re-establish Kenya's long tradition of openness to FDI and send a positive message to investors. If Parliament re-asserts previously expressed concerns about the need to protect national investors in key sensitive areas, an alternative approach could be based upon:

- Targeted protection for certain sensitive activities through specific entry restrictions;
- A proactive FDI promotion and targeting strategy, focusing on the type of investments likely to generate the largest benefits and linkages with the national private sector;
- Keeping the granting of special incentives separate from entry requirements.

A *negative list* approach would be best suited to achieve these objectives while at the same time preserving an investment-friendly environment. It would entail:

- Drawing up a *negative list* of carefully defined activities where foreign investment is restricted so as to allow protection of national investors in sensitive areas.
- The list would be determined by the Cabinet upon the recommendation of the Minister and the Investment Council. It would be drawn up following clear and publicly available principles that balance the benefits of protection of national producers against the costs of protection for consumers and other businesses. It would be reviewed periodically and applied flexibly so that growing businesses in restricted sectors would not be prevented from forming beneficial joint ventures with foreign partners.
- Foreign investment in *all other activities* would be open without restriction. In particular, FDI would *not* be subject to compulsory Investment Certificates and minimum capital requirements.
- Special incentives would remain conditional upon the investor – whether domestic or foreign – obtaining an Investment Certificate. The entitlement to a number of entry permits for foreign workers, in turn, would be linked to the amounts invested on a sliding-scale basis.

2. Policy Implementation and Coordination

The complexity and breadth of issues relating to the investment framework call for close coordination between all levels of government in policy formulation and implementation, driven by a clear and ambitious vision. The lack of consistent action on well-intended plans in the past also calls for increased monitoring and accountability of all agencies in their performance in improving the investment framework. Improvements in policy implementation, coordination and monitoring of performance should be led by the NIC and KIA.

a. National Investment Council

The Investment Promotion Act established the NIC as an advisory and monitoring body. Half of its members, however, are Ministers who have the executive powers to act upon the recommendations of the Council. In addition to providing general advice on policies to increase investment and promote cooperation between the private and public sectors, the NIC should immediately draw up a shortlist of priority policy actions to be implemented in the short term. This would imply setting agency-specific goals and targets and benchmarking performance to identify potential problems of implementation or under-achievers. The policy recommendations in this Review could serve as a basis for the list of actions to be taken up as a matter of priority.

b. Kenya Investment Authority

The role of KIA in policy coordination and monitoring should also be significantly expanded and strengthened. KIA needs to significantly boost its advocacy role to promote progress on issues of taxation, regulation and

infrastructure development, as well as its promotion and aftercare efforts. Its role would also be crucial in monitoring progress in actions recommended by the NIC and in promoting and monitoring the coordination of dealings with investors across agencies, as it is mandated to do under the Act.

3. Making the Current System Work

Given that much of the body of laws affecting investment is relatively sound, even though sometimes outdated, and that certain key sectoral laws have been updated in recent years, the Government should give priority to making the current system work better, while at the same time continuing longer-term work on a more complete overhaul of certain key laws. Three main principles should guide the authorities in this phase: (1) transparency; (2) efficiency; and (3) predictability. Applying these three principles to the current legal framework could bring substantial improvements in the investment environment in the short term.

The following should be considered as a matter of priority:

a. Simplify and Rationalize Business Licences

The temporary issuance of business licences to certified investors under the Investment Promotion Act does not address the problem of the licensing system at its core, as licences themselves are not scrutinized for their usefulness, purposes and effect on investment. There is thus still a need to reconsider the licensing system more fundamentally on the basis of the following principles:

- Repeal the Trade Licensing Act, thereby sending a strong initial message to investors that the Government is serious about advancing reforms.
- Remove all licences that are not indispensable for: (1) health protection; (2) protection of consumers' and workers' interests; (3) protection of the environment; and (4) safety.
- Simplify licensing procedures and establish communication channels and coordination between agencies granting licences, including through joint filings and inspections.
- Publish clear guidelines on criteria that must be fulfilled to obtain licences.
- Establish random and targeted inspections rather than systematic ones to ensure compliance with the standards set in the licences.
- Subject licensing agencies to benchmarking and performance reviews by the NIC.

The recent setting up of a Working Committee on Business Licensing with a mandate to take stock of all licences with a view to recommending those that must be retained, rationalized, amended or abolished is a step in the right direction. The Government indicated that up to 50 licences could be axed in 2005-2006, and it sent a Bill to Parliament to repeal the Stock Traders Licensing Act in June. It is crucial that this be carried through and that access to remaining licences be streamlined.

b. Combat Discretionary Powers

Many laws grant or leave the door open to significant discretionary powers to their administrators. Such discretionary powers, which sometimes run counter to the spirit of the law, have significantly increased the degree of uncertainty faced by businesses in their dealings with the administration, and are a major contributor to corruption, which is consistently identified by investors as a major impediment to business.

While amending the laws themselves to address this issue will be slow, much can be done in the short term by drawing up and making public a comprehensive set of regulations to guide government agencies more strictly in implementing the laws. Making regulations and guidelines public would serve several key purposes: (1) it would allow them to be assessed by the private sector; (2) it would enhance predictability for investors;

and (3) it would allow benchmarking of performance relative to the stated guidelines and regulations, both by the private sector and by the NIC.

In particular, the Government should rapidly publish clear procedures and guidelines for:

- The granting of Presidential exemptions on the allocation of agricultural land to foreign investors;
- The allocation of government land, until the more efficient and transparent system of auctions can be re-established;
- The granting of foreigners' work permits;
- The treatment of transfer pricing by the KRA.

c. Review the Process to Allocate Foreigners Work Permits

As detailed in section C.4, the Government should act upon the following three measures to facilitate investors' access to work permits for foreigners:

- Amend the Investment Promotion Act as suggested above and implement a sliding scale system for entitlements to foreigners' work permits.
- Replace the labour-market testing procedure with an Australian-type approach of pre-determined skills actively sought. Favour in particular the development of skill-intensive but low-capital foreign investments in the services sector that require expatriate workers.
- Replace the rigid understudy programme with more flexible requirements for training schemes for local employees.

d. Resolve Critical Bottlenecks

Infrastructure is both an impediment to and a potential magnet for FDI. While the regulatory framework needs further improvements, key actions can and should be implemented at once:

- Proceed faster and more forcefully with private sector involvement in the ICT sector, along the lines suggested in section C.11.
- Enact the Privatization Bill and accompanying regulations to ensure transparency, and initiate the privatization of assets in infrastructure and banking.
- Establish and enforce clear performance contracts that include international benchmarking and short- and medium-term targets for public sector companies that cannot be privatized rapidly, including for airports, ports, railways and utilities.
- Lobby Uganda to ratify the tripartite tax relief treaty and enact unilateral foreign tax relief for cases where DTT relief is not available.
- Establish and enforce clear performance benchmarks for the KRA and customs services in terms of VAT refunds, duty drawbacks and customs clearance times.

4. Modernizing the Legal Framework

Although the legal framework is mostly based on sound principles, this chapter has underlined that it needs modernization to reflect changes in business practices and evolving international best practices in regulation. While priority should be given to the measures detailed in sections D.1-3, work should also start on modernizing certain key laws, in order of priority:

- The Investment Promotion Act (see above);
- The Kenya Ports Authority Act;
- The Privatization Act;

- Negotiate and ratify additional DTTs with key partner countries in Africa and in FDI source countries;
- The Restrictive Trade Practices, Monopolies and Price Control Act;
- The Mining Act;
- The Companies Act and Bankruptcy Act;
- The Government Lands Act, Land Control Act and other land-related laws;
- The Employment Act, Regulation of Wages and Conditions of Employment Act. Negotiate and ratify additional BITs with key FDI source countries.

Private sector involvement in the infrastructure sector and the chances of success of the privatization programme would greatly benefit from a strengthened Commission of Monopolies and Prices. Legislative amendments should:

- Turn the Commission into an independent body with its own enforcement powers.
- Allow the Commission to investigate practices across all sectors, including electricity and telecommunications, and harmonize competition and sectoral laws. The Commission should work in consultation with the regulatory bodies, but its mandate should be wide enough to investigate anti-competitive practices in those sectors.
- Grant more flexibility to the Commission in regulating and approving M&As, particularly through a threshold rule.

III. A STRATEGIC AGENDA FOR FDI

A. Introduction

While the strength and level of development of Kenya's economy relative to its neighbours attracted market-seeking FDI until the early 1980s, rising levels of corruption, low growth and increasing operation costs have discouraged foreign investment in the past two decades. Kenya nevertheless has the potential to draw on its assets, including an industrial sector that remains more developed and has a longer history than in neighbouring countries, a relatively high level of human capital, the skeleton of a once-sound infrastructure network, and some financially strong and globally competitive companies to attract higher levels of FDI and sustain stronger economic growth. This is unlikely to happen without forceful and sustained reforms, however.

A review of FDI prospects suggests a strategy to reinforce Kenya's role as a regional centre for manufacturing and services activities, and to promote global competitiveness in certain key areas based on four pillars, including one whose potential is somewhat uncertain:

Pillar 1: Basic manufactures for the regional market

- Despite a relatively favourable legacy of manufacturing competence, Kenya has not attracted the FDI needed to seize the growing opportunities arising from the global relocation of manufacturing capacity from OECD countries to the developing world. Moreover, Kenya has not benefited from the global rationalization within TNCs of the commodity-like manufactures in which it specializes.
- A concerted and well-intentioned effort has been made to attract FDI in apparel export manufacturing based on AGOA preferences. Kenya, however, has not attracted those first-tier foreign investors with the capacity to remain competitive when these preferences expire.
- Less obviously but with nonetheless serious consequences, Kenyan manufacturing of basic consumer products and industrial inputs is losing ground in its own backyard, the East African Community and other neighbouring countries.

The near-term strategic imperative is to strengthen Kenya's ability to manufacture basic consumer goods and industrial inputs for the region by building on its existing manufacturing base, enhancing competitiveness and regaining lost market shares.

Pillar 2: Kenya as regional services hub

- Kenya is a natural hub for regional services and regional headquarters because of its high-quality manpower and its amenities. Many foreign investors based in Kenya sell services to the region. This position has not been actively promoted, however, and comparative advantages remain underexploited. The position of relative strength also cannot be taken for granted as competitive threats from within the region and from outside have already started to arise. On balance, there are still more opportunities than threats, however, and Kenya's penetration of the regional services market is still small.
- These opportunities for FDI have not been given sufficient strategic attention so far.

Pillar 3: Reinforcing the agribusiness success

- Export-led agribusiness has developed international competitiveness, in significant part due to FDI. The industry has flourished notwithstanding the infrastructure and policy difficulties that have undermined the traditional industrial base.
- A specific policy package to attract FDI is not essential for this industry. But its interests must be at the forefront of improvement in backbone services.

Unconfirmed Pillar 4: Diversification of FDI in EPZs

- The EPZs have attracted most of the new manufacturing FDI in recent years, with a strong focus on garment assembly for the US market under AGOA preferences.
- It is uncertain that existing foreign investors will remain after AGOA rules of origin tighten in September 2007 or that more competitive new FDI can be attracted.
- The EPZs will need to diversify into new niche markets, including by helping established investors to diversify. This diversification is an immediate and serious priority. Garment manufacturers in EPZs employ almost 40,000 people.

The relative strength of the national private sector is an asset that Kenya can draw upon to attract foreign investors in search of efficient local suppliers. A well-developed national private sector is also in many cases a prerequisite for the establishment of linkages between TNCs and the local economy, knowledge spillovers and other benefits deriving from FDI. Proactive measures to foster national businesses and FDI attraction policies should thus be seen as complementary and mutually reinforcing. In addition to general measures to improve the investment environment and a four-pillars-based FDI strategy, this Review thus suggests a broad outline of a national private sector development strategy.

B. Identifying Strengths, Opportunities, Constraints and Weaknesses

I. Strengths and Opportunities

a. Human Resources

Kenya has a long-standing societal commitment to education that is reflected in the Government's decision in 2002 to reintroduce free primary education. Significant progress was achieved over the past decades as the literacy rate among the population over 15 years of age increased from 56.2 per cent in 1980 to 82.4 per cent in 2000 (table III.1). This places Kenya among the top three performers in Africa, compares favourably with most Latin American countries, and approaches the situation of many Asian economies.

Gross enrolment ratio in secondary schools is also high for sub-Saharan African standards at 32 per cent, which means that the country has a relatively large pool of well-educated and trainable people. Although enrolment in tertiary schools remains low in absolute terms, around 70,000 students were attending public or private universities at the undergraduate and graduate level in 2002/03. The quality of education appears good as well, backed by a relatively low level of pupil to teacher ratio in primary schools and a high level of public expenditure on education as a percentage of GDP.

Table III.1 Educational Profile (2001/02 unless otherwise indicated)

	Kenya	Egypt	South Africa	U. R. of Tanzania	Uganda
Literacy rate (> 15 years)					
1980	56.2	39.3	76.1	49.0	45.9
2000	82.4	55.3	85.2	75.0	67.0
Gross enrolment ratio					
Primary	96.0	96.9	105.1	69.4	136.4
Secondary	32.0	88.1	86.4	5.8	16.8
Tertiary	2.9	38.3	15.0	0.7	3.2
Expenditure on education (% GDP)	6.2	n.a.	5.7	2.2	2.5
Compulsory education (years)	8	8	9	7	--
Pupil/teacher ratio (primary)	31.7	22.5	37.1	46.2	54.3

Source: UNESCO.

All investors interviewed recognized the high quality and wide availability of human resources. As one of them put it, “I have worked in South Africa, but people here are of a higher quality”. A leading exporter of horticultural products noted that two key comparative advantages of Kenya were its climate and its human resources. This means, for example, that it is able to use small-scale growers even though they are subject to extensive quality, environmental, traceability and phytosanitary standards required for exports to the European Union.

b. Location

With a deep-sea port and a well-developed airport (chapter II), Kenya has significant potential as a regional logistics hub. It is the main entrepot for the Great Lakes Region, one of the few African regions with outstanding agricultural potential, and also serves Uganda and the Western regions of the United Republic of Tanzania (currently trade from Arusha, to Mwanza, both in the United Republic of Tanzania, passes through Kenya).

c. Membership of Trade Agreements

Given the small size of its economy and low growth rates over the past decade, Kenya’s potential to attract market-seeking FDI for itself is rather small. Its active participation in a number of trade agreements, however, provides significant opportunities for investors. Kenya’s membership of the WTO is a positive factor for foreign investors, although not a determining one in the choice of location, as it is shared by another 146 countries.

In contrast, Kenya’s eligibility to AGOA offers investors increased opportunities to use the country as a platform for exports to the United States (see chapter II for details). The opportunities offered by AGOA, however, are also shared with another 36 African countries and grant tariff preferences for exports to one of the most fiercely competitive markets. Kenya has not been able to derive major benefits from the agreement since Congress ratified AGOA in 2000, with the notable exception of the garment industry (see section F). Excluding garments, Kenyan exports to the United States were nearly 9 per cent lower in 2003 than in 1999, the last year prior to the ratification of AGOA.

Similar conditions apply to Kenya’s being a signatory to the Cotonou agreement with the European Union, which gives it tariff-free and quota-free access for the majority of its goods. Membership of COMESA and the EAC offer more opportunities for market-seeking foreign investors, as both regional groups maintain higher rates of tariff and non-tariff protection on imports from non-members than the United States and the European Union, and are far less competitive.

d. Installed Capacity and Room for Improvement in Manufacturing Organization

Relative to its neighbours, the Kenyan industrial sector has some depth and breadth. The poor economic performance of the past decade also means that there is significant excess capacity in industry, even though some of the installed capacity has deteriorated as a result of a lack of investment or maintenance. The World Bank estimates aggregate capacity utilization at around 63 per cent (World Bank, 2003).

There are also significant weaknesses, however. Kenya’s industrial sector operates under old-fashioned management and production processes that have been made obsolete by more recent structures based on the concepts of Lean Production/World Class Manufacturing. These flexible forms of production organization provide significant and low-cost returns through, among other things, production-pulling, total quality control or cellular layouts. These forms of organization have been applied not just in high-income countries, but also in a variety of low-income economies (Kaplinsky, 1994). Visits to Kenyan manufacturing plants show that much of this organizational revolution has passed Kenyan industry by. Ironically, the very outdated nature of Kenya’s factory system could provide potential for investors, notably foreign investors, for output expansion and cost reduction at an attractive incremental capital cost.

2. Constraints and Weaknesses

a. Infrastructure

A long period of neglect, poor regulation and lack of financial resources have left much of Kenya's infrastructure in poor condition, both in absolute terms and in comparison with neighbouring and competitor countries. The World Bank (2000a) shows that investors rated the quality of infrastructure very poorly, in particular regarding roads, water and telecommunications (table III.2). About 90 per cent of over 100 surveyed investors rated the quality of roads and public works as "bad" or "very bad", placing Kenya in a much poorer position than the United Republic of Tanzania and Uganda, and dramatically worse than Egypt and South Africa. The same judgement holds true for telecommunications and water, whose quality investors also rated very poorly. Only in terms of electric power did Kenya rate similarly to or better than the United Republic of Tanzania and Uganda, yet with only 24.3 per cent of investors rating the quality of service as "good" or "very good", far below the satisfaction rates for Egypt and South Africa.

Although the World Bank's World Business Environment Survey was conducted in 2000, little appears to have changed either in terms of investors' satisfaction or in Kenya's position relative to its neighbours. Another survey conducted by the World Bank in 2003 indicates that 44.1 per cent of investors rate telecommunications infrastructure as a "major" or "very severe" constraint in Kenya, compared with 11.6 per cent and 5.2 per cent in the United Republic of Tanzania and Uganda, respectively. The survey indicates that it takes on average 124 days to obtain a phone connection in Kenya, compared with 38 days in Uganda and 23 days in the United Republic of Tanzania. The 2003 survey also confirmed the WBES results concerning roads and electric power, highlighting the problem that infrastructure in general is well below the standards expected by foreign investors and is a major impediment to business operations and cost competitiveness.

Table III.2 Quality of Infrastructure, 2000
(Percentage of investors rating quality as bad or very bad, and (good or very good))

	Roads/public works	Telephones	Power	Water
Kenya	91.0 (1.8)	64.5 (7.3)	28.8 (24.3)	67.6 (6.3)
Egypt	1.0 (60.4)	0.0 (79.2)	0.0 (72.3)	1.0 (64.4)
South Africa	6.7 (64.2)	5.0 (57.0)	0.8 (87.6)	1.7 (77.7)
U. R. of Tanzania	43.6 (17.4)	13.9 (46.8)	26.9 (12.8)	45.6 (3.8)
Uganda	23.5 (17.4)	13.4 (36.2)	47.7 (7.8)	13.2 (35.7)

Source: World Bank (2000a).

Electricity costs to business users, at about \$0.08 per kilowatt hour, are similar to those of Uganda, but higher than in the United Republic of Tanzania and significantly higher than in South Africa, which provides power to the subregion, including Lesotho, one of Kenya's major competitors for garment exports to the United States under AGOA (table III.3). Investors have also complained about the quality of electricity supply, with frequent outages obliging 70 per cent of investors surveyed by the World Bank to install their own back-up generators. Telecommunication services are of a rather poor quality and expensive, with a bright spot in mobile infrastructure, where foreign investment and competition have rapidly and dramatically improved the quality of services and lowered costs in recent years. International phone calls remain expensive even relative to other countries in the region, and fixed lines are subject to an extremely high level of faults.

Kenya shares some of its infrastructure problems with its neighbours, however, as its port infrastructure is used as a gateway to the rest of the world by Uganda, parts of the United Republic of Tanzania and other neighbouring countries. There have also been some improvements in recent years in the management of the port of Mombasa, and Jomo Kenyatta Airport in Nairobi remains a significantly more developed hub than its rivals in the region, offering improved services over the past few years (chapter II).

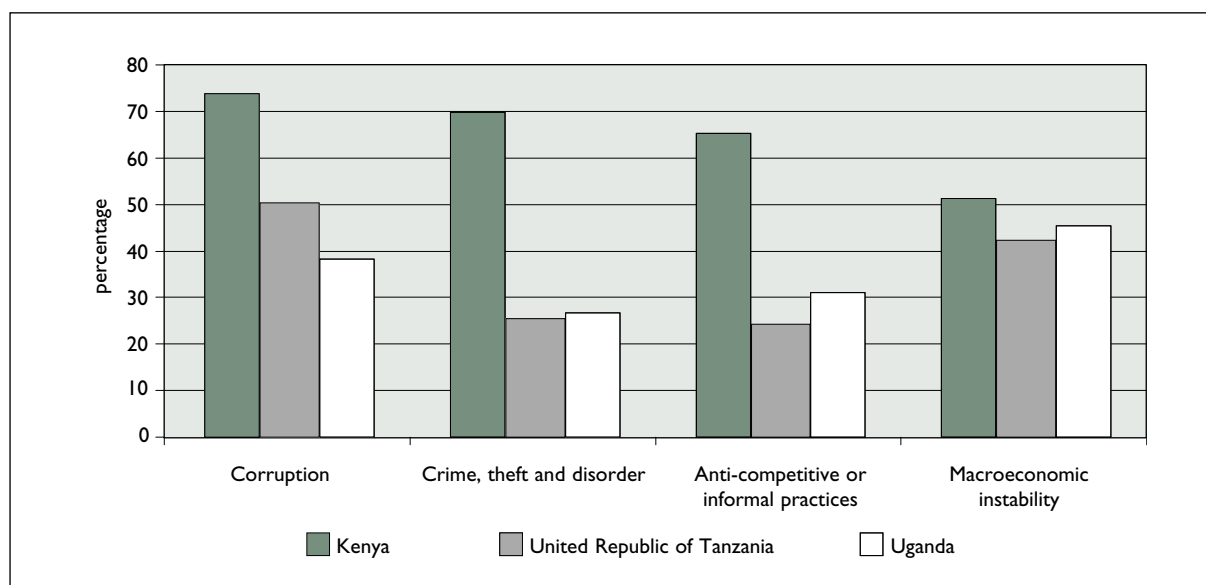
Table III.3 Infrastructure Indicators, 2004

	Kenya	Uganda	U. R. of Tanzania	S. Africa
Telecommunications				
Cost to USA per 3 minutes (\$)	3.75	3.51	5.28	0.58
Tel. faults per 100 mainlines per year	220.9	--	24.0	48.2
Prepaid cellular tariff per minute (local call, peak, \$)	0.2	0.19	0.25	0.27
Utilities				
Electricity charge per kwh (business use, \$)	0.083	0.08	0.0585	0.0274
Percentage of production lost due to power outage (survey of investors)	9.3	6.3	9.2	--
Transmission and distribution losses (per cent)	21.3	--	25.0	8.2
Water charge (per cubic metre, \$)	0.51	0.93	--	0.72

Sources: various national and international sources.

b. Corruption and Economic Climate

Corruption and the economic climate are major impediments to renewed FDI flows and a frequent concern raised by existing foreign investors. Over 70 per cent of investors surveyed in the World Bank Investment Climate Assessment evaluated corruption as “major” or “very severe” constraints on operations, significantly higher than in the United Republic of Tanzania and Uganda (figure III.1). Anti-competitive or informal practices (a reflection in part of corruption) were also cited as major constraints.

Figure III.1 Proportion of Firms Having “Severe” or “Very Severe” Constraints, 2003

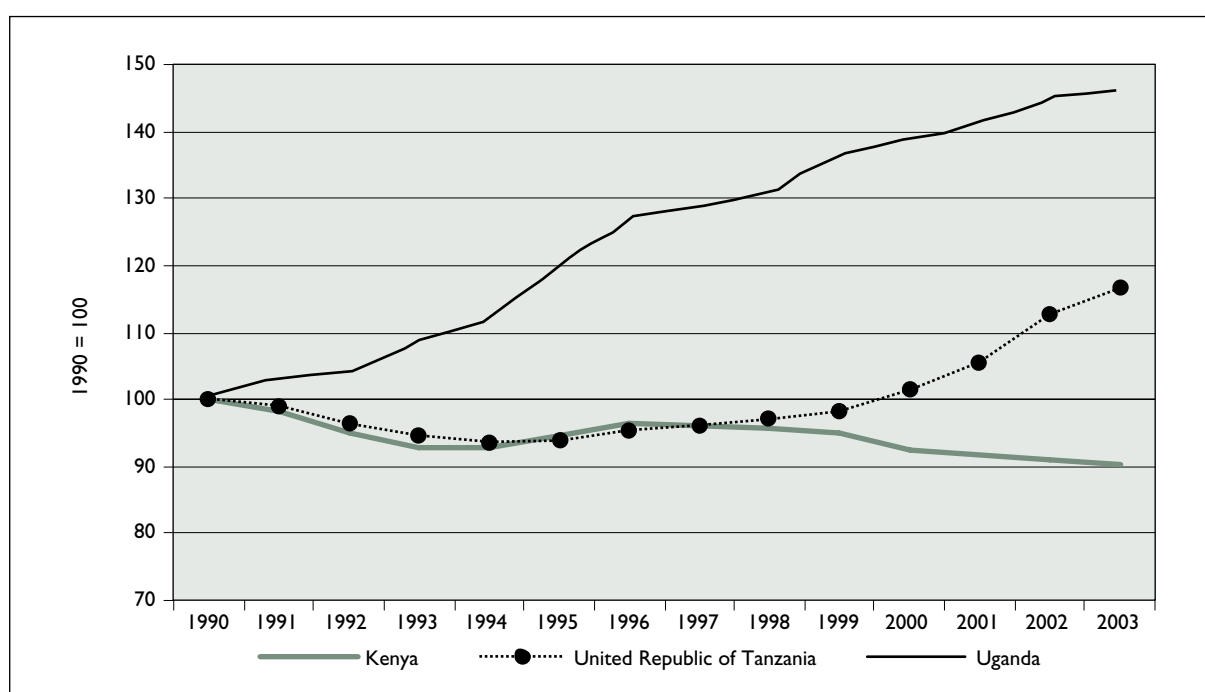
Source: World Bank Investment Climate Assessment, Kenya, 2003.

The issue of macroeconomic instability is also closely associated with the absence of growth. Indeed, as figure III.2 shows, per capita incomes in Kenya have declined in recent years. Incoming FDI is significantly influenced by the rate of economic growth, and in some countries such as Viet Nam, inflows of FDI continue despite high levels of corruption because the economy is growing rapidly. Foreign investors confirm that one of their major concerns with Kenya is its economic stagnation, and there is some sense that it is only when economic growth picks up that incoming FDI will flow into the country.

c. Institutional Infrastructure

Problems associated with widespread corruption and the virtual collapse of an effective agricultural extension service, as in the case of coffee, tea or cotton, have negatively affected the competitiveness of sectors using such goods as inputs to production. In earlier years, corruption led to severe problems in a range of agriculture-related extension-providing institutions. More recently, the attempts to reform these institutions have often led to their collapse, and in many sectors little support is provided to the farmers who provide inputs to manufacturers and value-adding post-harvest processors. This means that insofar as Kenyan producers participate in global markets, they do so in low-quality commodity segments, and suffer from adverse relative prices.

Figure III.2 Real GDP Per Capita, 1990-2003
(1990 = 100)



Source: World Bank, World Development Indicators.

d. Crime and Insecurity

The World Bank Investment Climate survey identified Kenya, compared with the United Republic of Tanzania and Uganda, as having an adverse image with regard to crime, theft and disorder (figure III.1). Almost 70 per cent of investors reported having “major” or “very severe” concerns about crime, theft and disorder, as opposed to 25 per cent in the United Republic of Tanzania and 27 per cent in Uganda.

3. Action Plan: Rebuilding Backbone Services and the Investment Framework

Sector-specific policies to attract FDI in key areas are unlikely to yield significant results unless they are accompanied by general measures to improve the foundations upon which all investments are based. Measures to address security and law-and-order issues are beyond the scope of this Review, but need to be addressed forcefully. An action plan to improve the investment framework in the short and medium term is proposed in chapter II. Further priority actions to strengthen the foundations for investment include the following:

a. Microeconomic Framework and Incentives Structure

Chapter II provides recommendations on ways to improve the investment framework as it affects foreign and domestic investors. Acting upon these recommendations to improve the incentives framework, and correct or prevent market failures, including through strongly pro-competition measures, is essential for the success of more specific sectoral strategies as recommended below.

b. Education

Although beyond the scope of this Review, continued support for education at the primary, secondary, tertiary and vocational levels is essential to sustained economic growth and FDI attraction. Continued dialogue between the private sector and the institutions providing education is essential in order to ensure that there is a good match between the skills required by investors and those gained at school.

c. Rebuilding Infrastructure

While Kenya benefited from relatively good infrastructure in the 1960s and 1970s, much of it either deteriorated dramatically through the 1980s and 1990s, or has failed to keep up with rising world standards and demands from investors. Rebuilding infrastructure is thus vital for reviving the economy and attracting or retaining foreign investors. Given the resource constraints facing the Government and in order to maximize the quality of services, the private sector should be at the core of infrastructure investments wherever a competitive environment can be achieved. This should by itself provide major opportunities for FDI attraction, as has already been the case in mobile telecommunications.

Chapter II provides further recommendations on the regulatory environment likely to attract foreign and domestic private investment in telecommunications and transport. Where involving the private sector directly in the provision of infrastructure services is not possible in the short term, the Government should elaborate and enforce clear performance contracts with public sector companies. This is most necessary in power transmission and distribution, water, and railways, where private sector participation is likely to require more time than in telecommunications, power generation, ports and airports.

The rebuilding of Kenya's infrastructure should have clear and realistic targets. The quality and cost of its backbone services need to be, at first, brought up at least to the level of Kenya's strongest regional competitor in manufacturing and services: South Africa. Aside from the regulatory and privatization-based strategy highlighted above, this would require to:

- Benchmark each backbone service against the quality and cost of such services in South Africa: power, water, roads, railways, ports, airports and telecommunications (fixed, mobile, internet);
- Survey investors about their most pressing needs in terms of infrastructure improvements;
- Establish targets against South African benchmarks, giving priority to needs highlighted by investors;
- Aim at benchmarking with respect to the best international and most competitive providers in the long term.

C. Pillar I: Basic Manufactures for the Regional Market

I. Global Trends

The past few decades have seen the rapid emergence of developing countries as industrial powerhouses and the relocation of production in many manufacturing sectors away from OECD countries. Much of this was made possible by the liberalization of trade flows (particularly manufactured goods) under the Uruguay Round and subsequent WTO agreements. The share of industrialized countries' exports of manufactured goods declined

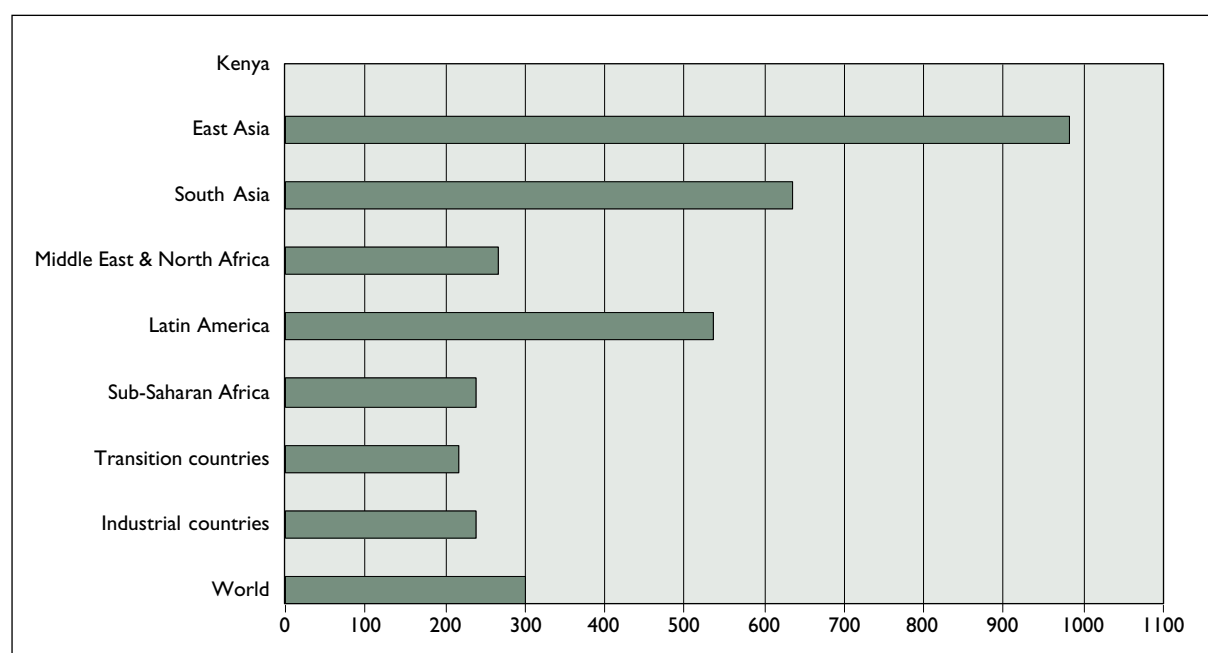
from 81.9 per cent of the world total in 1980 to 69.2 per cent in 2000 (table III.4). During the same interval also, world exports of manufactured goods more than quadrupled, far outpacing growth in world GDP. Multilateral trade liberalization opened the door to increased specialization and generated new opportunities for developing countries to produce and sell manufactured goods to the main consumer markets in industrialized countries. Not all developing countries have been able to derive benefits from these opportunities, however. East Asia succeeded in boosting its share of world exports of manufactured goods from 6.8 per cent in 1980 to 18.4 per cent in 2000. While Latin America also increased its participation in world exports of manufactured goods during the past decade, sub-Saharan Africa has essentially missed out on the opportunities offered by the opening of global markets. This is especially true for Kenya, whose manufactured goods exports have remained stagnant and whose share in world exports of manufactured goods had fallen by 2000 to only one fourth its level in 1980 (figure III.3).

Table III.4 Share in World Manufactured Exports
(Percentage)

	1980	1985	1990	1995	2000
Industrialized countries	81.9	80.4	80.3	73.9	69.2
Sub-Saharan Africa	0.7	0.5	0.4	0.6	0.6
East Asia	6.8	8.0	11.5	15.9	18.4
(China)	(1.0)	(1.2)	(2.5)	(4.6)	(6.5)
Transition economies	5.0	4.7	3.1	3.5	4.0
Latin America	3.2	3.6	2.4	3.7	5.1
Memo: Manufactured goods exports (billion dollars)	1 233.5	1 325.6	2 635.4	4 004.8	4 924.7

Source: UNIDO, Industrial Development Report, 2004.

Figure III.3 Percentage Change in Manufactured Goods Exports, 1980-2000

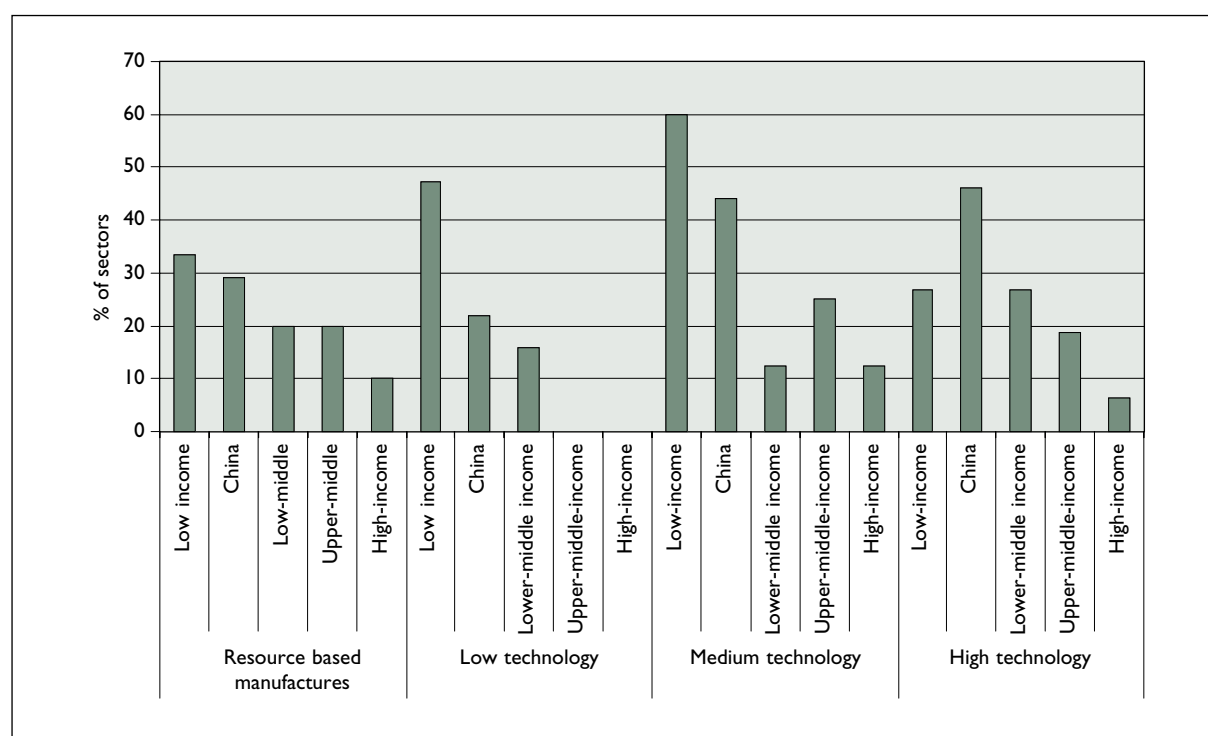


Source: UNIDO, Industrial Development Report, 2004.

The strong growth of trade in manufactured goods and the higher degree of specialization have also had a major influence on prices and location of production. Intense competition, further exacerbated in recent years by the growing participation of China in the global economy, has “commoditized” certain manufactured goods whose production has been continuously shifting across countries at various stages of their industrial development and which have seen their price fall sharply in recent years. The production of a wide range of final goods and intermediate inputs has increasingly been outsourced by leading international brands to producers in the developing world. The purchase of some manufactured goods has also become increasingly concentrated in the hands of a few global buyers with extensive bargaining power over the setting of prices, quality standards and characteristics of their orders.²⁷

Additionally, falling global transportation costs, regional trade agreements, increased competition and changes in production processes and management have led many of the largest TNCs to consolidate their production facilities around large regional blocs. This phenomenon is particularly significant for “commoditized”, low-technology goods with slim profit margins that are highly sensitive to production costs. Among the most significant “commoditized” goods are textiles and many low-technology manufactured goods, both capital- or labour-intensive. Although the declining trend in world manufacturing export prices is general, the prices of manufactured goods produced by low-income economies are most likely to have fallen (figure III.4).

Figure III.4 Percentage of Sectors with Negative Price Trends, 1988/9-2000/2001 by Technological Intensity and Country Grouping



Source: Kaplinsky (2005, forthcoming).

²⁷ This has been the case for some time in the garment industry, with most global brands outsourcing their production to factories in the developing world but specifying designs, delivery times, quality standards and other characteristics. It is also becoming more prevalent for other basic consumer goods, as global retailers such as Wal-Mart increasingly source them from developing countries and wield considerable negotiating power.

As a consequence of these trends, economies wishing to engage in the production of “commoditized” goods have to develop global competitiveness and operate on slim margins. Operating in these goods also requires constant increases in productivity and global benchmarking. Alternatively, countries have to develop their capacity to specialize in manufactures that do not display the characteristics of “commoditized” goods, namely innovation-based and knowledge-intensive products, or products for niche or regional markets that are not subject to the same level of international standardization and competition.

2. Kenya’s Manufacturing

Although the rapid increase in world trade of manufactured goods has provided major opportunities for developing countries, Kenya has by and large not been able to avail itself of them. Manufacturing companies have not succeeded in developing competitiveness in globally traded “commoditized” goods as a result of weaknesses in the investment environment, poor infrastructure and high operation costs. In particular, Kenya has had difficulties in seizing opportunities generated by trade liberalization in developed markets. The bulk of its exports to the European Union remains resource-based, namely mostly tea, coffee, flowers, vegetables or fruits (table III.5). Manufactured goods exports to the United States in contrast represent the majority of the total, but these are heavily concentrated in garments and total exports remain rather small at about \$170 million a year on average in 2000-2003.

Manufacturing nevertheless remains an important component of Kenya’s economy. While the share of the sector fell during much of the 1980s and the 1990s, from about 13 per cent of GDP in 1980 to 10 per cent in 1995, it recovered to 13 per cent in 2002. This is similar to the share of retail, restaurant and hotels, finance and business services or government services and amounted to about \$1.5 billion in 2002. Its contribution to formal employment amounted to about 230,000 jobs in 2002, 13.5 per cent of total employment in the private and public sectors.

Table III.5 Composition of Exports to the United States and the European Union
(Percentage of total, period average)

	United States		European Union	
	1996-99	2000-03	1997-99	2000-03
Tea and coffee	25.6	15.2	43.3	27.9
Flowers & plants	0.2	0.6	15.1	24.8
Vegetables & fruits (incl. prepared)	3.4	1.5	20.4	24.0
Manufactured goods	41.6	66.4	5.2	6.0
Memorandum: Total exports (million dollars)	106.4	169.1	899.0	825.6

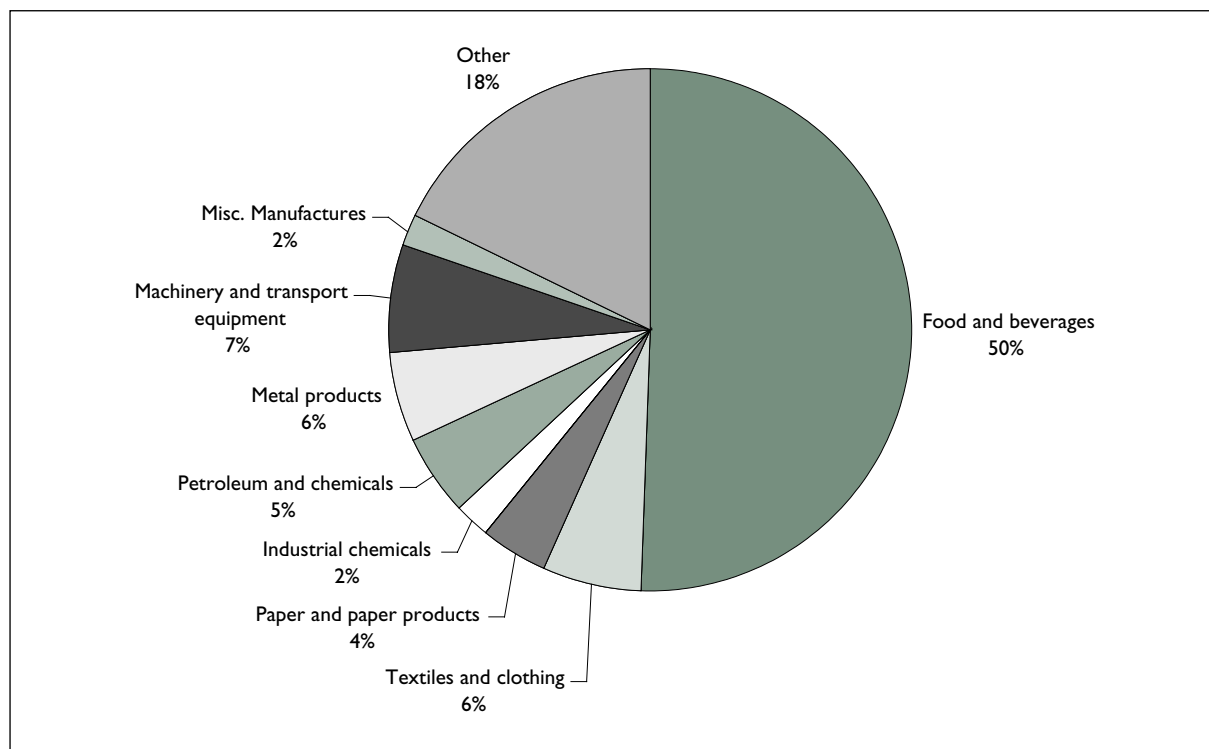
Source: based on imports from the United States and European Union, USITC and EuroStat.

The main contributors to industrial value-added are in basic consumer goods and industrial inputs, including notably foods and beverages. The contribution from garments has also been rising in recent years as a result of renewed exports to the United States following the ratification of AGOA in 2000 (see section F) and the creation of Export Processing Zones (EPZs). Food and beverages accounted on average for about 50 per cent of industrial value-added in 2000-2002 (figure III.5). The contribution of basic consumer goods and industrial inputs to employment in manufacturing is also large. Food-related products accounted for over 30 per cent of formal employment in manufacturing, with basic industrial inputs such as pulp and paper, metal and plastic products accounting for another 20 per cent.

Kenya also remains relatively more industrialized than its neighbours. This, together with preferential access to neighbouring markets under COMESA and the EAC, the adaptation of products to local tastes, the presence of TNCs using Kenya as a regional production centre and advantages related to proximity (easier transport and fewer problems with goods susceptible to degradation), has allowed Kenya to remain a significant provider

of manufactured goods to the region, in spite of the lack of global competitiveness of its manufacturing sector. Several TNCs have had a long presence in the foodstuff and basic consumer goods sectors. This includes Coca-Cola, which has been in Kenya since 1948, works with eight locally-owned bottling plants and directly employs around 1,900 people. Global brands in the consumer goods industry such as Colgate Palmolive and Procter&Gamble have had a long presence as well.

Figure III.5 Composition of Industrial Value-Added
(Percentage of total, 2000-2002)



Source: Statistical Abstract 2003, Central Bureau of Statistics.

Foreign investors have also had a significant presence in sectors producing basic industrial inputs or in niche markets. Key among these are paper and paperboard, non-metallic mineral manufactures (glassware and pottery) and iron and steel products. Tetra Pak of Sweden, which supplies complete systems for processing, packaging and distribution of food products, set up in Kenya in the 1950s and started producing packaging products in the 1970s as a result of close cooperation with a local paper mill.

Kenya's exports of manufactures reflect the sector's loss of dynamism described above. About 70 per cent of exports of basic consumer goods and industrial inputs²⁸ in 1998-2000 went to the United Republic of Tanzania, Uganda and COMESA. This share has also been rising over the past decade.

Currently, seven key neighbours²⁹ (SKN) are the most important market for Kenya's manufactured goods. Over 2000-02, Kenya was the source of close to 8 per cent of total imports from the SKN, all of which are members of either the EAC or COMESA (table III.6). All the SKN are least developed countries (LDCs), a fact which implies that this market remains small. It is far from negligible relative to Kenya's own economy and manufacturing sector; however, as SKN imports from Kenya averaged around \$500 million a year in 2000-2002.

²⁹ Democratic Republic of the Congo, Ethiopia, Rwanda, Sudan, United Republic of Tanzania, Uganda, Zambia.

Some of these countries have also experienced high growth rates over the past few years and represent revived market opportunities.

While the lower degree of competition in the subregion than in the global economy has sheltered Kenya’s manufacturing to a certain extent, competition has nevertheless started to increase both from within and from outside the area. Hitherto, Kenya has benefited from a dominant role in the SKN market in a range of basic manufactures that have not been subject to fierce international competition. The relatively better economic performance of neighbouring countries in recent years has nevertheless started to erode Kenya’s edge in manufacturing, even though it continues to export significantly more manufactured goods per capita than its neighbours. More significant threats come from further afield, however.

While Kenya accounted for 8.6 per cent of the SKN imports of basic consumer goods and industrial inputs in 1994-1996, its share halved to 4.2 per cent by 2000-2002 (table III.6). The only area where it managed to maintain its market share was in oils, fats, toiletries and pharmaceuticals. While all of the SKN except the United Republic of Tanzania are members of COMESA, the sharpest competition did not come from within the trade bloc. The loss of market share was not due to competition from Egypt or other COMESA countries, but mostly to the rapid emergence of South Africa as a supplier of choice, and to a significant extent as well China and India (figures III.6 & III.7).

Figure III.6 Market Shares in Seven Key Neighbours Imports, Oil, Fats, Soaps, Toiletries and Pharmaceuticals
(Percentage of total imports, period average)

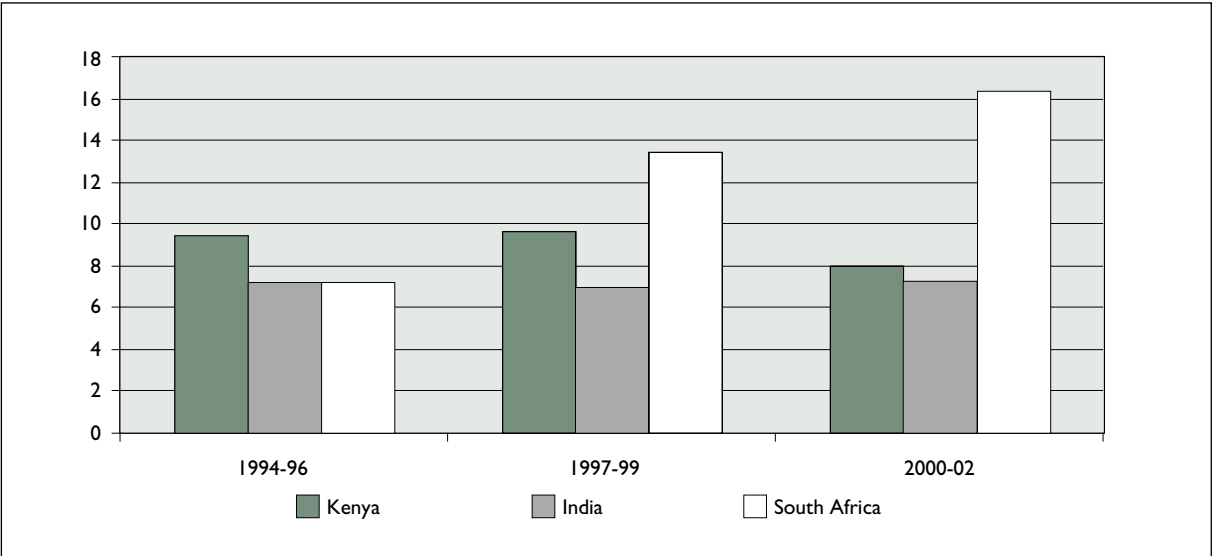
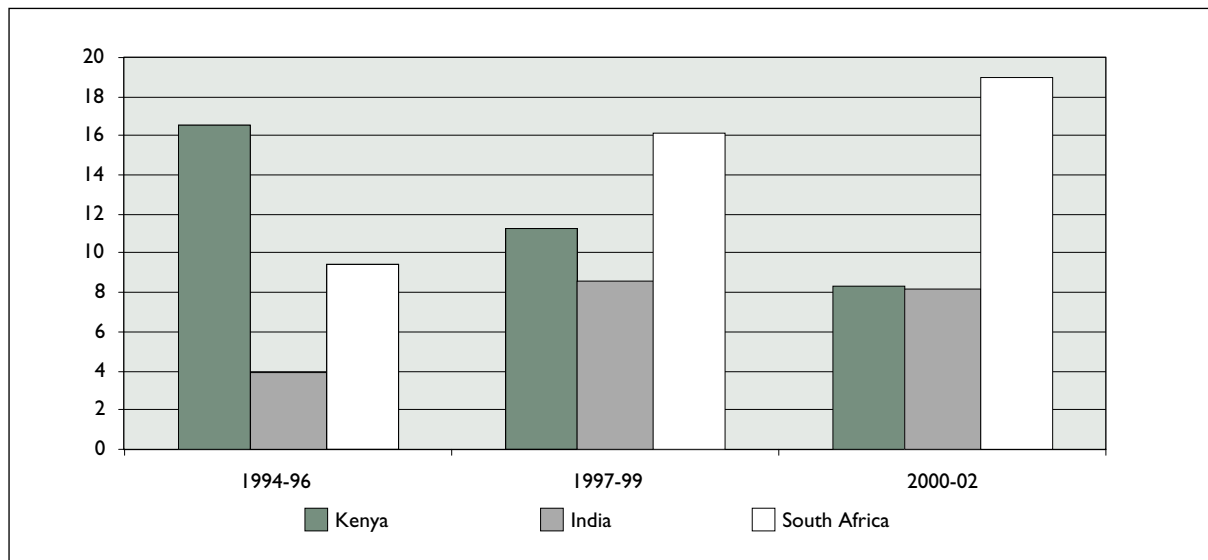


Table III.6 Market Shares in Seven Key Neighbours' Imports
(Percentage of neighbours' imports originating from the listed country, period average)

	1994-96	1997-99	2000-02
Total imports			
Kenya	8.5	7.9	7.7
China	2.2	4.0	5.5
Egypt	1.8	0.9	1.2
India	4.2	4.6	4.7
South Africa	6.2	11.7	14.5
Basic consumer goods and industrial inputs			
Kenya	8.6	6.1	4.2
China	2.3	4.5	5.9
Egypt	1.7	1.0	1.3
India	4.7	4.8	4.9
South Africa	7.1	13.0	15.2
Food-related processed goods			
Kenya	9.0	6.2	2.1
China	0.1	0.8	1.3
Egypt	2.9	1.7	2.2
India	1.5	1.0	3.0
South Africa	5.8	12.4	10.5
Oils, fats, soaps, toiletries and pharmaceuticals			
Kenya	9.5	9.6	8.0
China	1.1	1.6	3.3
Egypt	2.2	0.8	1.7
India	4.8	7.0	7.2
South Africa	7.2	13.4	16.3
Basic industrial inputs (metal, paper, etc)			
Kenya	16.5	11.3	8.4
China	3.9	8.6	8.1
Egypt	2.7	1.7	2.1
India	3.0	6.4	6.4
South Africa	9.5	16.1	19.0
Other misc. manufactured goods			
Kenya	3.9	2.5	1.7
China	2.7	4.7	7.0
Egypt	0.7	0.5	0.7
India	6.4	4.4	4.0
South Africa	6.3	11.6	14.4
All other (incl. petroleum, horticulture, tea and coffee)			
Kenya	8.2	14.5	20.2
China	1.7	1.9	4.0
Egypt	2.1	0.6	0.7
India	2.4	3.8	4.1
South Africa	2.8	7.2	11.8

¹Democratic Republic of the Congo, Ethiopia, Rwanda, Sudan, United Republic of Tanzania, Uganda, Zambia.
Source: UN COMTRADE, data from importing countries.

Figure III.7 Market Shares in Seven Key Neighbours' Imports, Basic Industrial Inputs
(Percentage of total imports)



Source: UN COMTRADE database.

It is also of concern that Kenya has not only been bypassed as a country of choice to relocate manufacturing activities from industrialized nations, but has also suffered from a wave of delocalization of existing manufacturing activities to other developing countries. TNCs such as Colgate Palmolive, Procter&Gamble and Unilever, which have had a long presence in Kenya and are sizeable producers and employers in manufacturing, have all downsized their production facilities in Kenya to consolidate their regional production centres elsewhere in Africa. Downsizing in Kenya has resulted partly from global corporate strategies to reduce the number of production centres and streamline supply chains and partly from high production costs (box III.1).

Box III.1 Colgate Palmolive Operations in Kenya

Colgate Palmolive has had manufacturing operations in Kenya for about 40 years, serving the domestic and regional markets. Over the past decade it has rationalized its global operations into seven regional divisions, systematically concentrating production within each of these regions. Its Latin American region made major changes during the 1990s, reducing the number of plants from 17 to 7, with greater intraregional specialization and trade.

A similar process of rationalization is now rolling out through its African subsidiaries. Its Kenyan operations are significantly affected, with many products being removed and sourced instead from South Africa, and with the Kenya factory serving the COMESA market for a limited range of products. Since 1995, sales have remained constant in real terms, exports (including re-exports) have risen to 30 per cent of sales, local production has halved and employment has fallen by more than 20 per cent. Significantly, however, Kenya is becoming the organizational hub for regional operations, including sales and marketing.

Source: investor interview.

3. Action Plan: Pursuing Regional Opportunities in Manufacturing

The erosion of the manufacturing sector's comparative advantages and competitiveness in Kenya's own backyard is a significant threat at a time when tapping global market opportunities is made difficult by the high operation cost and inability to compete in thin-margin "commoditized" goods. This calls for a structured programme to encourage existing TNCs to maintain or expand their presence in Kenya, before even seeking to attract new foreign investors in manufacturing. A policy of FDI attraction and revival of the manufacturing sector should thus focus on:

- Regaining a footing in the regional market;
- Building upon the regional market to determine and develop niche opportunities and achieve competitiveness at the global level in the medium to long term.

A proactive policy could be built upon a double axis of upgrading tax and regulatory policies from a neutral to an incentive stance, and introducing a competitiveness programme for the sector as a whole.

a. A Proactive Tax and Regulatory Stance

Although Kenya's tax regime does not put domestic producers at a particular disadvantage with respect to competitors in the region, and particularly South Africa (see chapter II), shifting from a neutral to a proactive tax stance could enhance the country's attractiveness to foreign investors seeking a manufacturing basis in East Africa. The Government should also be increasingly proactive in securing market access to its key neighbours under terms at least as favourable as competitor countries, and South Africa in particular. Given Kenya's competitive position, regional trade agreements are set to be more important still to its manufacturing sector than market access to the larger industrialized countries under AGOA, ACP or the WTO, except in specific circumstances such as the garment industry.

The lack of parallelism between the development of regional trade agreements and the harmonization of tax policies also implies that countries in the region are increasingly competing against each other to serve as regional platforms for TNCs to serve the regional market. Preferential or free-trade areas decrease the relevance of tariff barriers as factors in the location decision of market-seeking FDI, which makes production costs and tax regimes all the more important in determining TNCs' decision to locate their production facilities. As a result, Kenya should take particular care in maintaining tax and market access competitiveness relative to other countries in the region, and it is recommended in that respect that it:

- Consider a lower tax rate on foreign source income of Kenyan companies. While further research should be done to determine the appropriate level, taking into account rates in EPZs in regional competitors, a rate of 15 per cent, as opposed to the general rate of 30 per cent, could be a starting point.
- Push for the enlargement of the free-trade COMESA-II area to other members of COMESA, with priority given to Ethiopia and the Democratic Republic of the Congo.

b. A Competitiveness Programme: Introducing World Class Manufacturing

Much of Kenya's domestic manufacturing sector has been stuck in a time warp, using outdated forms of productive organization, ranging from poor cash flow management to poor floor layout, handling of stocks or orders forecasting. There are then considerable returns to systemic reorganization, drawing on the principles of World Class Manufacturing (WCM). A competitiveness programme to promote the diffusion of WCM across Kenya's manufacturing sector could significantly boost national private sector development, enhance the competitiveness of domestic enterprises and provide a stronger setting for linkages with foreign investors in need of efficient, reliable and competitive local suppliers. The programme should be structured along the following lines:

Awareness

- Most of Kenya's domestic industry is unaware of the concept and potential gains of WCM. An awareness campaign, wholly funded by the Government should be put in place in close cooperation with, and subcontracting to, the local consulting sector.
- The campaign should target as a matter of priority manufacturing enterprises involved in the production of basic consumer goods and industrial inputs, as well as companies providing inputs to foreign investors.
- The United Kingdom's Enterprise Initiative established in the 1980s is an effective role model for this campaign. The "Inside U.K. Enterprise" scheme, in which 160 best-practice companies opened their doors to managers from other firms, could be replicated in Kenya. Participation by existing TNCs applying WCM should be actively sought.

Benchmarking

- The Government should partially fund benchmarking initiatives on a sector-wide area so as to allow the various sectors to assess their performance with respect to regional and global competitors. At the

Box III.2 Fostering Firm-Level Upgrading: The South African Experience

When the new Government came into office in South Africa in 1994, it was faced with an industrial policy closely integrated with an outdated, costly and internationally unacceptable trade policy regime. This trade policy regime protected imports and subsidized exports. The Government opted to move from "demand-side" policies to "supply-side" policies designed to enhance productive efficiency. Among these policies, three directly targeted the upgrading of manufacturing organization:

- The Workplace Challenge provided subsidies for consultancy services for changes in workplace organization.
- The Competitiveness Fund provided subsidies for firms restructuring their business strategy and internal organization.
- The Sector Partnership Fund provided subsidies to groups of firms joining together to achieve collective efficiency.

At the turn of the 1990s the South African auto industry appeared to be in terminal decline, with low volumes and proliferation of models. Within a decade it had become a strong performer and has made significant strides as an exporter of both autos and components. A number of factors drove this restructuring, including the Government's Motor Industry Development Programme, and the demands of the foreign-owned assemblers for quality improvement and cost reduction. An important additional factor in the sector's growing competitiveness was the Benchmarking Clubs. These drew on the Sector Partnership Fund, which provided two thirds of the cost of starting and running learning networks.

Allying a benchmarking programme to structured activities of continuous improvement, Benchmarking Clubs allowed firms to make spectacular progress in upgrading their performance. As a side effect, the consulting group that set up the Benchmarking Clubs has developed a range of skills that have led to their:

- Leading a benchmarking-continuous improvement programme for the textile and clothing industry (at the industry's request);
- Selling their services globally by marketing their benchmarking data.

See: www.bmanalysts.com; www.autelligence.com.

regional level, South Africa should serve as the key benchmark, given its position as the main competitor. Lessons could also be drawn from South Africa's upgrading programme in the automobile industry (box III.2).

- The Government should partially fund benchmarking initiatives at the company level so as to assess the individual needs of each firm and its strengths and weaknesses relative to domestic, regional and global benchmarks. The United Kingdom's Enterprise Initiative or the "Programme de Mise à Niveau" in Tunisia both provided government funding, up to a limit, to cover the cost of employing business consultants.

Learning Networks

- The attractiveness of Kenya as an FDI destination depends not only on the availability and quality of backbone services, but also on the efficiency of the entire supply chain, which can only be as strong as its weakest link. The awareness and benchmarking efforts should thus be complemented with sector-specific learning networks.
- Specific fiscal incentives could be granted to upstream firms that serve as "network brokers", i.e. those that initiate firm cooperation and training within the supply chain. Expenses directly related to suppliers' improvements (similar to what GM does with its suppliers, as illustrated in box I.3) should be subject to special tax credits.

Although this competitiveness programme is unlikely to attract FDI per se, it should help to improve the attractiveness of Kenya as an investment destination inasmuch as it could raise the quality of entire supply chains and encourage existing investors to maintain or expand their presence in Kenya. It would foster national private sector development, promote backward and forward linkages, and re-establish a sense and image of dynamism in the manufacturing sector. The programme should involve local consultants, who could thus raise their skills and experience to a level that can be exported to the region (see section D).

D. Pillar 2: Kenya as a Regional Services Hub

I. Global Trends

As with manufactured goods, yet more belatedly, world trade in services has boomed in the past decade. The liberalization of international trade in services under the WTO (and on a unilateral basis by many countries) and technological changes that have eased international transactions in services are the major factors behind such growth. World imports of services nearly doubled between 1990 and 2002 to \$1630 billion, closely tracking the increase in world imports of manufactured goods (figure III.8).

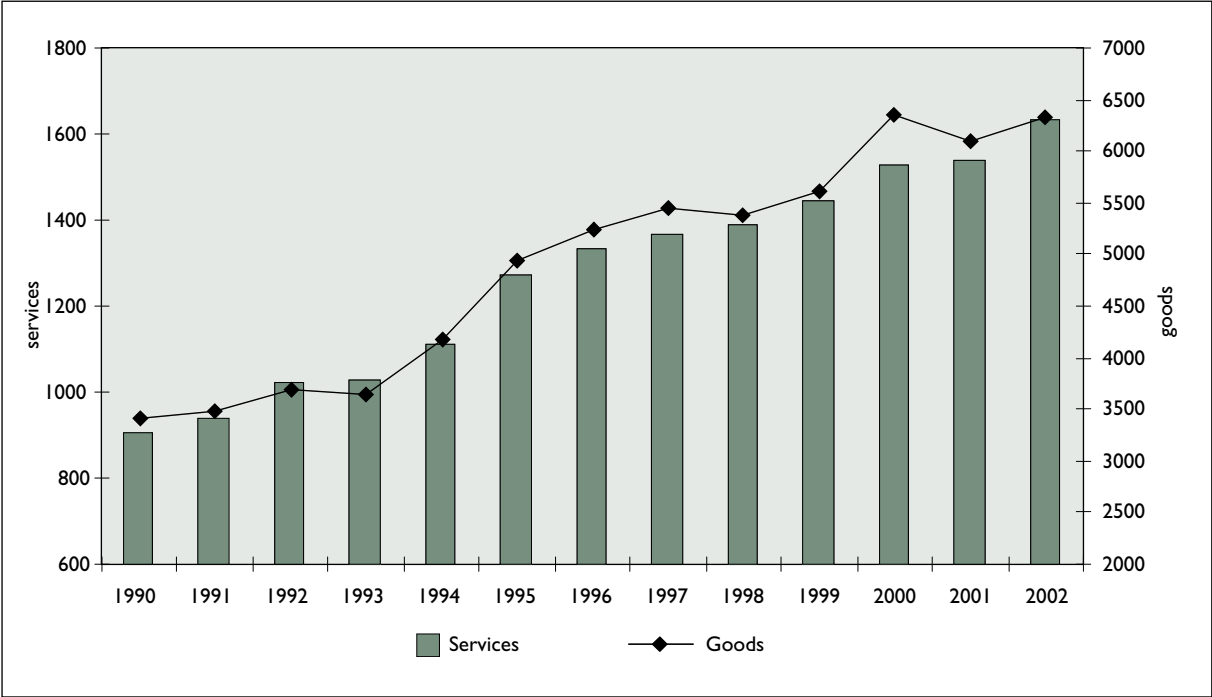
The globalization of the services sector has affected developed countries more than developing countries, in part due to the larger proportion of their economies that is accounted for by the tertiary sector. Developing countries have nevertheless become increasingly significant players in the global production of services, as illustrated by the debate about the outsourcing of services jobs to countries such as India or China. FDI has also become increasingly focused on the services sector, which accounted for about two thirds of total FDI flows in 2001-2002 (about \$500 billion). The services sector in general remains less transnationalized than the manufacturing sector, however, which leaves much room for further growth in services FDI.³⁰

FDI in the services and knowledge-intensive sectors in developing countries has typically been driven by three factors. The first wave of services FDI was mostly linked to the provision of services to goods-producing TNCs. This included investments by banks, accounting firms or transport companies setting up operations to provide services first to other TNCs, and secondly to other large domestic firms. The second driver of services FDI was linked to the liberalization and privatization of a range of services that used to be provided by public

³⁰ UNCTAD (2004).

monopolies or were heavily restricted and regulated. Such market-seeking services FDI became particularly significant in the 1990s in utilities (electricity and water), telecommunications, retail or banking, among others. More recently, technological advances in information and communication technologies have increased the tradability of many services and triggered a third wave of efficiency-seeking services FDI.

Figure III.8 World Imports of Goods and Services, 1990-2002
(Billion dollars)



2.A Regional Services Hub

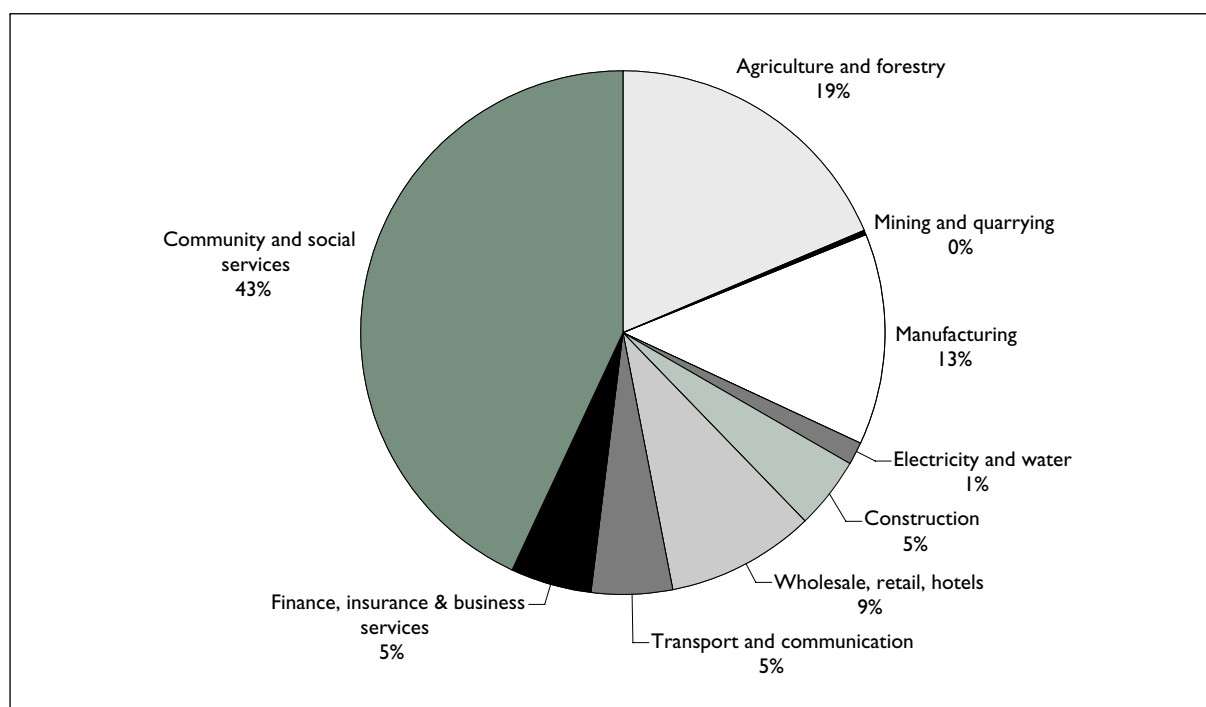
The services sector (including government and public services) accounted for about 54 per cent of GDP in Kenya in 2002, up from 49 per cent in 1990. Aside from government services, which accounted for about 18 per cent of GDP in 2002, finance and business services represented 13 per cent, and trade, hotels and restaurant another 16 per cent. The services sector also represented 68 per cent of formal employment in 2002, with wholesale, retail and hotels being the largest non-government employer (figure III.9).

A number of foreign investors in the services sectors have been long established in Kenya, including Barclays, Citibank and Standard Chartered in banking, Deloitte Touche Tohmatsu and KPMG in accounting, auditing and consulting, Ayton Young & Rubicam in advertising and marketing, Maersk in transport and logistics, and others in education, tourism and other sectors. These firms were established mostly to provide services to goods-producing TNCs and to capture local market opportunities. More recently, foreign independent power producers (IPPs) have moved to Kenya, and Vodafone of the United Kingdom and Celtel of South Africa have taken a share in mobile phone operators.

So far, however, Kenya has not been able to attract much efficiency-seeking FDI of the latest generation, despite its comparative advantage in the region in terms of skills and educated labour force. Total exports of knowledge- or skills-based services (i.e. excluding tourism and government transactions) rose to \$490 million in 2003 from \$330 million in 1997. This was accounted for almost exclusively by transport services, which are

significantly linked to the tourism sector, and the increase mostly reflects the success of Kenya Airways after its privatization. Exports of communication, insurance, finance and other services were only about \$40 million in both years (table III.7).

Figure III.9 Employment by Sector in Kenya, 2000-2002
(Percentage of total)



Source: Statistical Abstract 2003, Central Bureau of Statistics.

Table III.7 Exports and Imports of Services
(Million dollars, period average)

	1991-1993	1994-1996	1997-1999	2000-2002
Kenya (exports)				
Total services	1040.0	1026.0	893.1	1033.6
Commercial, finance & other	73.9	68.3	40.2	40.5
Transportation	243.7	271.5	322.4	422.7
Travel	431.9	478.4	326.4	289.2
Government	290.5	207.8	204.1	281.2
Seven neighbours¹ (imports)				
Total services	2232.7	2879.7	3429.8	3586.3
Commercial, finance & other	975.1	1222.9	1325.6	1298.9
Transportation	875.4	873.9	1220.8	1528.2
Travel	283.0	547.0	678.4	560.0
Government	99.3	178.8	205.1	199.2

¹ Democratic Republic of the Congo, Ethiopia, Rwanda, Sudan, United Republic of Tanzania, Uganda, Zambia.
Source: IMF Balance of Payments Statistics.

It must be noted, however, that a number of services providers, including in the banking, accounting, auditing, taxation, consulting, advertising, construction and architecture or legal sectors use, Kenya as their regional hub because of the higher quality of human resources (box III.3). This does not fully show or translate into large services receipts in the statistics, as collected for balance-of-payments purposes.

The recent global drive in services FDI offers significant opportunities for attraction of investment in Kenya given its relative position of strength in the region in terms of skills and human resources. While much of the FDI in services is likely to be of a market-seeking nature at first, Kenya is well positioned to serve as a regional “efficiency” or “excellence” centre, and may also be in a position to attract some global efficiency-seeking FDI in niche areas, particularly under its EPZ scheme.

The recent global wave of services FDI has concerned both intra-firm services provision and provision to outsiders (business to business (B2B) and business to consumer (B2C)). The “commoditization” of certain goods, falling prices and reduced margins have pushed large manufacturing firms to analyse their value chains and outsource activities subject to increasing competition to low-cost producers, many of which are in the

Box III.3 Regional Services Providers

A number of companies in a variety of sectors already use Kenya as a hub for the provision of services to the region. These include:

- **Deloitte Touche Tohmatsu.** The firm uses Kenya as its East Africa hub even though it also has offices in other countries in the region. The Kenyan operation provides consulting, tax and accounting services in the EAC as well as in Ethiopia and Sudan, and derives around 20 per cent of its gross revenue from non-Kenyan services.
- **Kenya Airways.** The company has expanded significantly since its privatization in 1996 and has transformed Jomo Kenyatta Airport in Nairobi into a regional hub for passenger services. Its cargo operations have also grown significantly over the past few years. Cargo bound for non-African destinations is mostly loaded with Kenyan goods, but the company is also used by other African countries for inward-bound cargo. Kenya Airways also set up an engineering school that offers training in aircraft maintenance services. The school is certified by the United Republic of Tanzania Civil Aviation Authority, Malawi Civil Aviation Authority and Uganda Civil Aviation Authority to conduct courses on Boeing 737-300 aircrafts, and it attracts students from these three countries.
- **Citibank Kenya.** Although all of Citibank’s sub-Saharan African branches report to South Africa, Kenya is a “centre of excellence” and the branch provides services to other branches in the region, including product research, risk management and treasury management.
- **Ayton Young & Rubicam Group.** The firm uses Kenya as its hub for the provision of advertising and marketing services to East Africa and bases its entire strategy on the region, given the small size of each market taken individually. It recently formed an alliance with MCL of Uganda and currently derives around 20 per cent of its gross revenue from the region, up from 5 per cent in 2000.
- **Symbion.** The architecture and interior design firm based in Kenya offers services throughout the region and works for companies that also operate on a regional basis. Around 30 per cent of its gross revenue is derived from operations outside Kenya.
- **United States International University.** The largest of five tuition-funded private universities with about 3,000 students (out of 8,500 in private universities and 63,000 in public universities), USIU welcomes students from 45 countries (mostly in Africa) and has around 500 foreign students (15 per cent of enrolment). Its certification in the United States and exchange programmes with universities in the United States and elsewhere prove particularly attractive to students from other African countries.

Source: investor interview and websites.

South. In terms of intra-company services activities, this has meant that activities retained at the headquarters in the source country include system integration and architecture, design, IT, marketing and the coordination of logistics and quality in global and regional value chains. Lower-skilled services such as data-entry, document and data processing, call centres or other back-office operations, in contrast, have increasingly been sourced in low-cost countries. While many TNCs have chosen to outsource the production of these services to low-cost countries, they have often retained control of their operations by setting up their own affiliates rather than fully outsourcing to an external provider.

Although such type of FDI has remained small in Kenya, some companies, including Colgate Palmolive, have indicated that they use Nairobi as their regional base for the provision of intra-company services, including auditing, marketing, quality assurance, logistics control or even adaptation of products to local markets. There is scope to expand the delivery of these services on an intra-company basis, drawing on the relative depth of Kenya's human resources. In that respect, Kenya could even build on the recent increase in manufacturing FDI in neighbouring countries.

Most of the FDI that Kenya has attracted so far in extra-firm services has been to serve the local and regional market. B2B services FDI partly provides the same type of services as are provided within TNCs, as some of those choose to outsource part of their operations both to low-cost countries and to outside firms. This has been the case particularly for call-centres, accounting, data entry and processing or telemarketing, among others. Cost considerations are vital in the decisions to locate such type of B2B services providers, even though other considerations such as language skills, time-zone location, reliability and quality of support services and cultural affinities (in particular when interaction with customers is required) may also play a primordial role. The delivery of these services usually relies on ICT infrastructure, which means that it is vital to have reliable and high-quality ICT (e.g. high-quality phone lines for call centres) at a competitive cost, in addition to a skilled labour force.

On basis of the current structure of Kenya's services sectors and its comparative advantages regionally and globally, a classification of areas of opportunities for FDI attraction and development is presented in table III.8. Realizing the potential, partly through a proactive policy of FDI attraction in these subsectors, would require policy action, however.

Table III.8 Areas of Opportunities in Services Sectors

	Regional	Global
B2B	<ul style="list-style-type: none"> - Banking and financial services - Insurance - Engineering, architecture - Audit, taxation, consulting - Legal services - Marketing, advertising - Market research - Conference centre - Back-office operations (database management, data entry and processing, electronic publishing, remote secretarial services, telemarketing/call centres) - Transport/logistics/courier. - Cultural services (audio-visual, printing, editing) - Telecommunications - Information technologies 	<ul style="list-style-type: none"> - Back-office operations (database management, data entry and processing, electronic publishing, remote secretarial services, telemarketing/call centres, technical support)
B2C	<ul style="list-style-type: none"> - Health - Education (secondary and tertiary) - Transport - Financial, asset management - Tourism - Architecture 	<ul style="list-style-type: none"> - Tourism - Transport

3. Action Plan: Kenya as a Regional Services Hub

The Government has given little strategic attention to the services sector (apart from tourism) either as a magnet for FDI or as the foundation for growth. As a result, the services sector still suffers from a negative bias in the policy framework vis-à-vis manufacturing. The development of Kenya as a regional services hub nevertheless offers significant opportunities for FDI attraction, high-skill job creation, exports and growth. Key impediments must be removed, however, and the country should not take its position for granted as competitive pressures will increase in the coming years. A strategy to promote services FDI and build regional leadership should be based upon the policy actions described below.

a. Minimum Capital Requirements for FDI

Investments in the services sector are typically skill-intensive and require relatively little capital injection when compared with industrial projects. The minimum capital requirement of \$500,000 imposed since the beginning of 2005 for *all* FDI projects is a formidable impediment to the development of Kenya as regional services hub. Little FDI in the services sector is likely to take place unless that restriction is lifted, and it places Kenya at a large competitive disadvantage vis-à-vis the United Republic of Tanzania, Uganda, or other neighbours. The general restriction thus needs to be lifted as a matter of urgency. The Government has recently taken action to do so by sending amendments to Parliament to lift minimum capital requirements on FDI (see chapter II). As recommended in chapter II, targeted restrictions on FDI entry could nevertheless be granted in certain sensitive areas if Parliament were to express concern about reverting to a fully open FDI regime. Such areas would most likely relate to the provision of services for the local market, however, and not affect foreign investors seeking to use Kenya as a hub for the provision of services to the region.

b. Tax Measures

The Government's lack of focus on the services sector as a source of growth and FDI attraction means that issues of taxation policy pertaining specifically to services have been given little attention. Tax policy is currently an inhibiting rather than a facilitating force, and the following reshaping is suggested:

International Taxation

(i) Lower the corporate tax rate on foreign source income.

- This measure, as already suggested for manufacturing, should also apply to services so as to promote Kenya as the location of choice for services TNCs aiming to serve the regional market.
- A 15 per cent rate should be considered, as rates in EPZs and in less tax-sensitive offshore services in Africa are coalescing around this level. This would provide a competitive tax environment and would likely be acceptable to the OECD under its harmful tax initiative.

(ii) Provide unilateral relief from double taxation of income.

- The small number of DTTs and the absence of treaties with neighbouring countries (aside from Zambia) are key impediments to the growth of the services sector and the promotion of Kenya as a regional hub as they generate a heavy tax burden that can amount to about 50 per cent on foreign source income.
- Efforts to negotiate and ratify a wide network of DTTs with countries in the region and major source countries of FDI should thus be intensified.
- While DTTs are the optimal solution to the problem of double taxation, their negotiation and ratification are lengthy, as illustrated by the lack of entry into force of the 1997 Tripartite Agreement within the EAC.
- The need to rapidly develop Kenya as a regional services hub and gain a leadership position to build upon calls for unilateral foreign tax credit to be provided at once.

(iii) Strive to reduce services fee withholding taxes in treaties with regional countries.

- Kenya's potential as a regional services hub should be reflected in lower rates of withholding tax on services fees in regional DTTs. The Tripartite Agreement with the United Republic of Tanzania and

Uganda has not achieved any reduction in withholding rates imposed by the two partners. The Government should strive for more favourable outcomes in negotiations with other regional countries, as was achieved in the DTT with Zambia, which exempts services fees from withholding taxes.

Domestic Taxation

The Government's policy focus on manufacturing means that domestic taxation is biased against the services sector. This should be eliminated by:

- Extending the "investment deduction" available on fixed assets employed in manufacturing (and in tourism) to services, including business and professional services. This means allowing immediate expensing of commercial buildings and other capital investments (computers, office furniture, and others), as opposed to the current depreciation rates of 2.5 per cent per annum (buildings) and 30 per cent per annum (computers). Future policy changes on investment deductions should apply equally to manufacturing and services investments.
- The 5 per cent withholding tax on agency fees should be reduced to the lower of a moderate flat fee or 1 or 2 per cent of the invoice value, as suggested in chapter II. This should strengthen the cash flow of business and professional services providers without the compliance value of the arrangement being lost.

c. Regional Market Access

FDI in the services sector is likely to be predominantly market-seeking initially. Maximizing market size through regional agreements on services should thus be a primary target of government policy. While significant progress has been made within both COMESA and the EAC on the creation of preferential or free-trade areas, little has been done to reduce barriers to trade in services, whether these arise from licensing requirements, restrictions on movements of people or other factors. Given the complexities of issues pertaining to the liberalization of trade in services, the Government should focus its efforts first on the EAC, and to a lesser extent on COMESA.

The EAC Treaty and the associated Development Strategy 2001-2005 clearly specify the priority areas in terms of trade in services. Now that negotiations on the setting up of the Customs Union have come to an end, the Government needs to act forcefully with its EAC partners to advance faster in:

- Developing mutual recognition of qualifications of professionals;
- Pushing for more accommodative immigration and labour market regulations to promote the movement of professionals within the EAC;
- Removing legal and professional barriers (including licensing requirements) to trade in: (1) accounting and auditing; (2) management and consultancy; (3) building and construction; (4) engineering and architecture; (5) legal and taxation services; (6) banking; and (7) marketing and advertising.

Similar efforts should be undertaken with partners within COMESA or the COMESA-II subgroup, even though progress is likely to be slower and more difficult than at the EAC level.

d. Human Resources

Developing a successful regional hub requires allowing companies to attract and retain the most qualified people and talent -- citizens and non-citizens. This calls for an advanced human resources strategy and a significantly more flexible foreigner work permit policy, which has been biased against services investors. This policy bias needs to be corrected, along the lines that were recommended in chapter II. More specifically, the following measures should be considered:

- Apply the recommendations on foreigners' work permits of chapter II.

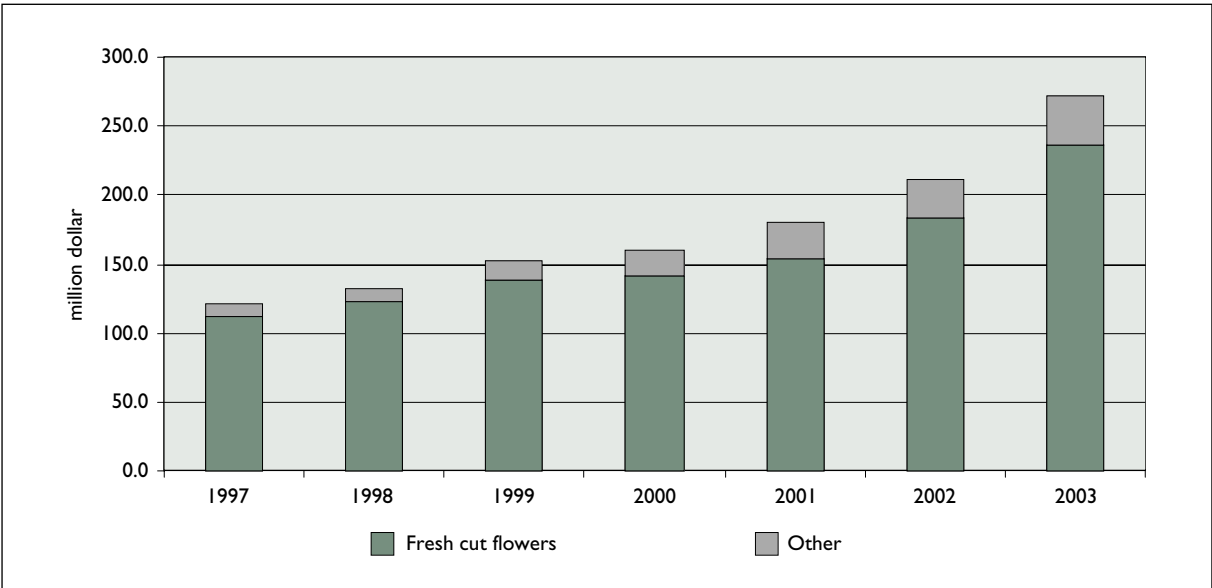
- In particular, the services sector should be designated a strategic priority and benefit from: (1) a fast-track key positions scheme and; (2) a pre-designated set of positions open for foreign hire without requirement for employer-based labour market testing.
- Review measures to attract highly-skilled overseas Kenyans to return for employment and business at home. This could include improved tax treatment of passive income from assets retained abroad, better tax treatment of stock options and favourable tax treatment of relocation expenses and of income from and contributions to existing overseas pension funds.

E. Pillar 3: Reinforcing the Agri-business Successes

I. Recent Developments

Favourable land and weather conditions and acquired skills, technology and processes have enabled Kenya to build a demonstrated comparative advantage in the production of flowers, fruits and vegetables for the world market. The sector has been a major success story, with exports to the European Union –and to some extent to the United States– growing rapidly over the past few years (figure III.10).

Figure III.10 Floriculture Exports to the EU-15
(Million dollars)



Source: Eurostat.

Kenya’s success in providing high-quality products at competitive costs and in fulfilling strict sanitary and phytosanitary standards (SPS) is the result of private investment and initiative, as the flower, vegetables and fruit sectors have been subject to relatively little government intervention through extension services to farmers or public marketing boards. Exports by these three sectors have consistently increased as a share of total exports over the past decades, growing to an aggregate of close to 23 per cent in 2003, equivalent to \$550 million, from less than 6 per cent in 1980.

Large firms dominate these export-oriented agri-business sectors, with 24 industrial operators accounting for 72 per cent of total export volume. The dominance of large firms is not due to capital intensity, however, but results from the need to meet the demanding standards of buyers for food safety, traceability, environmental

impact and labour standards. Indeed, flower, vegetable and fruit production are very labour-intensive, and cut flowers alone employ 40-50,000 people directly and another 60-70,000 indirectly. While the distribution side of the three sectors is dominated by foreign equity, linkages with the domestic agricultural sector are sizeable -- particularly in the flower and vegetables sectors -- as production is frequently ensured by a range of locally-owned outgrowers.

Two key areas of technological competence are essential in distributing and selling products to the EU and US markets. The first is to ensure adequate traceability and environmental standards. While this is widely recognized to act as a disincentive to small-scale producers, some of the largest (foreign-owned) exporters use small-scale outgrowers, and provide them with the extension services necessary for sustaining their market position.

The second key area of technological competence lies in the control of logistics. Kenyan growers and packers add value to fresh vegetables by undertaking the full range of pack-house activities, including washing, packing and labelling the produce with store-specific packaging and labelling. Their control over logistics and production allows their European customers to change their purchase requirements up to the middle of the day of dispatch in large aeroplanes flying to Europe every night. Similarly, logistics in the flower sector enable the full cold-chain storage of flowers immediately after picking, which allows supermarkets to guarantee their produce for one week after sale from the store.

As mentioned earlier, these sectors have flourished with little government support. Some services are provided by the Horticulture Crops Development Agency (HCDA) and the Kenya Agricultural Research Institute (KARI). The Kenya Plant Health Inspectorate Service is the regulatory agency for quality control of agricultural input and produce. It coordinates all matters relating to crop pests and disease controls, tests and monitors the quality of seeds and fertilizers and is in charge of phyto-sanitary inspections. Private sector companies, in turn, established the Kenya Flower Council in 1997 and set up their own guidelines and standards in terms of labour practices, environmental protection and quality controls, and promote a "Kenya" label in Europe.

There remains considerable scope for expansion in the flower, fruits and vegetables sectors despite the growth of recent years. Kenya is the largest non-EU exporter of live trees and flowers (HS code 06) to the European Union, with exports of \$270 million in 2003 (table III.9). Total exports (including among EU countries), however, represented close to \$8 billion in the same year, highlighting the considerable potential for future growth through even moderate increases in market shares. The considerable number of direct passenger flights from Jomo Kenyatta Airport to Europe contributed to the initial development of flower exports, when volumes would not necessarily justify dedicated cargo flights, which have since then become more significant with higher volumes. Fresh cut flowers represent the bulk of flower exports to the European Union.

In contrast, the absence of direct flights to the United States has essentially prevented the export of fresh flowers to that country. As a result, Kenya only managed to export \$1.7 million of trees and flowers (HTS code 06) in 2003, mostly in dried form. Total US imports of trees and flowers nevertheless represented close to \$1.3 billion in 2003, providing considerable potential for future market development as well.

Although Kenya's position in the exports of fruits and vegetables is not as strong as for flowers, the country has been successful in niche markets in the European Union. Exports of edible vegetables excluding preparations (HS 07) to the EU-15 were \$150 million in 2003, only 1 per cent of the total (table III.9). Dominant among these were exports of beans and peas, for which Kenya has a year-round production capacity at consistently high-quality levels.

Exports of edible fruits excluding preparations (HS 08) to the European Union were small at \$34 million in 2003, and have not been growing significantly over the past few years (table III.9). Production of fresh fruit for export is also highly concentrated in avocados, which represented over 80 per cent of the total in 2003.

In contrast, South Africa exported over \$1 billion, Côte d'Ivoire \$300 million and Cameroon \$215 million in 2003. The absence of direct flights from Kenya to the United States and strict certification requirements for the export of fresh fruit and vegetables nearly shut Kenyan producers off from the US market. Exports of fresh fruits were only \$6 million in 2003, with virtually no exports of fresh vegetables.

Fruit and vegetable preparations offer additional market opportunities where transportation is somewhat less of an issue, and have significant scope for expansion. Exports of fruit and vegetable preparations (HS 20) to the European Union were \$78 million in 2003, only 0.6 per cent of the total (table III.9). Exports to the United States were also negligible at \$1.2 million. Canned pineapples currently represent the bulk of exports of fruit and vegetables preparations, with Del Monte the main producer of both canned and fresh fruit, despite its global shake-up in the past few years.

Table III.9 Largest Horticulture and Floriculture Exporters to the EU-15 and United States, 2003
(Million dollars and market shares)

	EU-15		United States		
	Million dollars	Market share	Million dollars	Market share	
<i>Cut flowers and live trees</i>					
Kenya	271.5	3.4	Kenya	1.7	0.1
Israel	162.6	2.1	Colombia	347.5	27.8
Colombia	108.0	1.4	Canada	329.8	26.4
Intra-EU15 ¹	6594.1	83.3	Netherlands	231.5	18.5
Total	7919.1	100.0	Total	1249.0	100.0
<i>Edible vegetables, excluding preparations</i>					
Kenya	152.5	1.0	Kenya	0.0	0.0
Morocco	341.4	2.3	Mexico	2119.0	58.7
Poland	272.6	1.8	Canada	743.9	20.6
Intra-EU15 ¹	12076.7	80.6	Peru	112.8	3.1
Total	14984.3	100.0	Total	3607.6	100.0
<i>Edible fruits, excluding preparations</i>					
Kenya	34.1	0.1	Kenya	6.0	0.1
United States	1076.8	4.7	Mexico	907.0	19.8
South Africa	1006.2	4.3	Chile	794.7	17.4
Intra-EU15 ¹	12645.0	54.6	Costa Rica	518.7	11.3
Total	23139.0	100.0	Total	4577.6	100.0
<i>Fruit and vegetables preparations</i>					
Kenya	78.0	0.6	Kenya	1.2	0.0
Brazil	740.5	5.4	Canada	718.8	22.3
Turkey	464.1	3.4	China	345.1	10.7
Intra-EU15 ¹	9971.8	72.8	Mexico	310.3	9.6
Total	13690.7	100.0	Total	3225.5	100.0

¹ Exports among EU-15 countries.
Source: EuroStat and USITC.

2. Action Plan: Reinforcing Agri-Business

Horticulture and floriculture have thrived in spite of the problems in the investment climate over the past couple of decades as a result of natural and acquired comparative advantages and private sector investment. While the sector is already large in terms of output, employment and exports, it still has significant room for

expansion and could further attract foreign investment. Additional FDI could also be attracted in other agri-business sectors, including processed fruit and other food products.

Direct government involvement in horticulture and floriculture should not increase from the current stance, which is relatively hands-off and has worked well. The Government should nevertheless consider indirect policies to support the sector and improve operating conditions, paying particular attention to suggestions from private companies. Government policy in other agri-business sectors, in contrast, may be more direct. Direct and indirect measures could include:

- An improvement in road infrastructure connecting the main growing areas and airports. While constraints on its resources may not allow the Government to bear the whole cost of road development, some of the infrastructure would be particularly well suited for concession agreements under build-operate-transfer (BOT) or build-operate-own (BOO) terms.
- Tax deductions with respect to the costs incurred by major firms that provide training to their outgrowers so as to enable them to comply with SPS. This could further favour the outsourcing of production to small farmers and the transfer of skills, and promote national private sector development.
- Ensuring that Kenya CAA obtains certification from the US FAA so as to allow Kenya Airways to operate direct flights to the United States if it so desires.
- Approaching US airline companies to explore the possibility of establishing direct flights linking Kenya to the United States.
- Seeking synergies between the tourism sector and horticulture/floriculture so as to allow the progressive penetration of the US market through the availability of cargo space on passenger flights.
- In that respect, the Government could launch a campaign to promote Kenya as a tourism destination in the United States, and target major US tour operators to invest in Kenya.
- Improving access to agricultural land for foreign investors. While complications in access have not prevented long-established foreign investors from playing a predominant role in horticulture/floriculture, they are a likely impediment to additional FDI in agri-business, especially from new entrants. In addition to the recommendation on agricultural land of chapter II, the Government could explore the possibility of setting up pre-approved land tracts available for agricultural development. These would be auctioned to national and foreign investors with pre-qualified development credentials.
- Diversification of the agri-business sector could be promoted through active government involvement in extension services for fruit production. A foreign-owned global fruit processor could be identified and targeted to establish operations in Kenya.
- An active effort to brand Kenyan tea and coffee internationally, through a joint public-private partnership of government and business stakeholders, along the line of the efforts undertaken by Colombia in the past.

F. Unconfirmed Pillar 4: Diversification of FDI in EPZs

I. Recent Developments

Export processing zones were created in 1990 in order to attract outward-oriented investment, both domestic and foreign. A total of 36 EPZs were established or under development as of 2004, the majority of them around Nairobi and Mombasa, and some being one-company zones. Athi River, the single largest EPZ, is developed and operated by the Government, and provides better-than-average infrastructure services, which include guaranteed water supply and a first-in, last-out privilege in the event of power outage.

Although investment in EPZs was relatively modest in the 1990s, the introduction of AGOA and the granting of special preferences for apparel, including fabric sourcing requirements, generated a burst of FDI, particularly by Asian-based garment companies seeking quota access to the US market (see chapters I and II). As of 2004, there were 70 companies operating in EPZs representing a total investment of about \$220 million and

employing around 40,000 people, or 19 per cent of private formal sector manufacturing employment. Of these companies, 40 operated in the textiles and garments industry and accounted for close to 60 per cent of total investment, about 95 per cent of employment and over 70 per cent of exports (table III.10).

Table III.10 Investment in EPZs by Sectors

	Share of (percentage)			
	No. firms	Employment	Investment	Exports
Textiles/garments	31	95.8	54.3	73.8
Chemicals/oils	5	0.4	9.9	5.9
Computers/electricals	3	0.2	0.5	0.2
Agro-processing	3	1.9	1.4	5.7
Printing	2	0.8	26.6	10.2
Pharmaceuticals	3	0.3	1.5	1.9
Services	6	0.2	3	1.9
Gemstones	1	0.3	3	0.3

Source: Export Processing Zones Authority.

Virtually all of Kenya's textiles and garments exports consist of apparel sold to the United States under AGOA. Under current rules, the United States grants Kenya and other sub-Saharan African countries quota-free and duty-free access for its apparel output. Although preferential access is normally subject to rules of origin that require that fabrics be sourced either in the United States or in other AGOA countries, Kenya (along with many other African countries) was granted an exception until September 2007 that allows it to source fabrics anywhere, including in Asia.

While the European Union also allows preferential access to Kenya, it does not grant exemptions on sourcing requirements and rules of origin. As a result, textile and garments exports were virtually non-existent at less than \$2 million in 2003. In contrast, exports to the United States were \$280 million in 2004, seven times as high as the pre-AGOA level in 1999. Essentially all of Kenya's exports to the United States consist of apparel and clothing accessories. Among these, women's or girls' suits, ensembles, dresses or trousers represented 50 per cent of the total, with the same articles for men and boys accounting for another 21 per cent.

Restrictions on international trade in textiles and clothing under the Multifibre Arrangement (MFA) have been wide-ranging in the past decades and have significantly affected the pattern of flows. It was agreed in 1995 to dismantle the MFA and to bring trade in textiles and clothing under normal WTO rules through a 10-year transitional Agreement on Textiles and Clothing (ATC). Bringing textiles and clothing under normal WTO rules

Table III.11 Composition of Textile and Clothing Exports to the United States
(Million dollars)

	2001	2002	2003	2004
Total	64.7	125.9	188.0	277.3
Cotton	60.1	95.0	154.3	236.1
Men's & boys' trousers, shorts	20.1	29.7	37.7	57.9
Women's & girls' trousers, slacks	36.8	53.3	83.9	138.4
Man-made fibres	2.2	25.0	27.6	33.5
Men's & boys' trousers, shorts	0.8	4.1	4.6	4.0
Women's & girls' slacks, shorts	0.3	7.2	5.4	6.2
Highly-constrained categories	58.6	109.9	169.6	256.1
(percentage of total)	(90.6)	(87.3)	(90.2)	(92.3)

Source: USITC.

requires the full elimination of quotas, but does not imply the elimination of preferential tariff arrangements. Quotas on a minimum of 16 per cent of goods were eliminated on 1 January 1995, with further reductions on 17 per cent of goods in January 1998 and 18 per cent of goods in January 2002. The transitional ATC lapsed on 1 January 2005, when all remaining quotas were eliminated and textiles and clothing trade fully fell under normal WTO rules.

The gradual phasing out of quotas has significantly affected international trade patterns in textiles and clothing, with a few key countries rapidly gaining market shares for items whose quotas were eliminated, despite continued differences in tariff treatment. A detailed analysis of Kenya's textile exports to the United States shows that a large and rising share is accounted for by items whose quotas were only eliminated in January 2005. In 2004, 92 per cent of Kenya's textiles and clothing exports to the United States were for items qualified by the US International Trade Commission as "highly-constrained quota categories" (table III.11).

Box III.4 Sri Lankan Apparel Companies in Kenya

Seven Sri Lankan companies have invested in recent years in EPZs to export garments to the United States under AGOA. These companies provide a test case of the sustainability of the garment industry as quotas are eliminated and duty-free rules of origin tightened under AGOA after 2007. Sri Lanka itself is the 11th largest exporter of clothing to the United States (2002).

The outlook is not encouraging. The "big three" of the Sri Lankan industry are MAS Holdings, Brandix and Hidramani. Each is making substantial investments in Sri Lanka to integrate backwards and to form strong relationships with branded clothing ranges and large retailers in order to stay competitive as remaining quotas are lifted in 2005. This process has been under way for several years. Meanwhile, many other garment producers in Sri Lanka have shut down and some have relocated. None of the big three has invested in Kenya, even though it was short-listed by one of the companies, which eventually invested in Madagascar. Another of the big three has also invested in Madagascar.

Kenya has attracted smaller Sri Lankan companies that are undertaking cut-make-trim of imported fabric for AGOA exports. It is doubtful whether any have the management and financial capacity to achieve the two key requirements of sustainability beyond 2007:

- Investment in the production of fabrics and accessories, entailing tens of millions of dollars of investment;
- Creation of strong relationships with major brands and retailers. On the contrary, it is estimated that a single intermediary buys 70 per cent of the garments assembled by Sri Lankan companies in Kenya.

Building backward integration and strong customer relationships takes many years. It appears that Kenya has started too late and too small to build an integrated industry. Substantial fabric production has not commenced. The accessories investors have not been established and Kenya has not attracted the major apparel investors needed to create an integrated industry.

Even under the current AGOA regime, the Sri Lankan-owned garment producers are facing competitive pressures. One has shut down and two have amalgamated. One of the more successful Sri Lankan producers in Kenya is considering expanding but is likely to locate the expansion in either the United Republic of Tanzania (which has lower labour costs than Kenya) or Ghana (which has lower labour costs and is offering a package of concessions). Nevertheless, the expansion will only be for garment assembly and no commitment beyond 2007 is being made.

Source: investor interviews.

The data above highlight the fragility of the garment industry in EPZs, which appears to have developed over the past four years as a result of large quota-driven trade distortions that have just been eliminated and temporary preferences that are to lapse at least partly in September 2007, when the United States is set to end the current exemption on fabric sourcing requirements for preferential access. That exemption was initially planned to end in September 2004, but was extended for another three years.

The absence of diversification away from highly-constrained quota categories of apparel over the past few years and the insignificant level of exports to the European Union are worrying indicators that foreign investors in the garment industry, the majority of which are from Sri Lanka, China or India, have chosen Kenya mostly for quota-hopping reasons. Kenya has attracted smaller companies involved in cut-make-trim of imported fabrics. It has not succeeded in attracting the larger investors with the key management and financial requirements to be successful in a more competitive environment: an integrated supply chain and strong relationships with major brands and retailers (box III.4).

A visit to a large Asian-owned EPZ firm suggested minimal investment in fixed equipment (no computerized grading or cutting). Logistics and quality were also rather poorly handled, with bundle sizes frequently in excess of 150, and extensive reworking of work-in-progress. This suggests little investment in training and just-in-time logistics. It therefore seems unlikely that tariff preferences and EPZ incentives will be sufficient to entice those investors to maintain production lines in Kenya beyond September 2007.

The largest competitors for Kenya's most significant garment exports can be seen in tables III.12 and III.13. China is the most significant threat, as it has already emerged as the largest supplier for items HTS 6204 and HTS 6110, despite being subject to quotas and normal trade relations (NTR) duty rates, which typically range between 7 per cent and around 30 per cent, depending on the specific items. The surge in US imports from Vietnam in 2002-2003 following the bilateral trade agreement granting NTR in 2001 and the temporary absence of quotas also suggests that Kenya may lag far behind in terms of competitiveness with countries such as Viet Nam.

Table III.12 Top 10 Sources of US Imports of Women's or Girls' Suits, Ensembles, Dresses, etc, Not Knitted or Crocheted (HTS 6204), 2001-2004
(Million dollars)

	2001	2002	2003	2004
Total	10 204.7	10 026.2	11 116.0	12 168.1
China	1 380.6	1 427.9	1 802.3	2 360.9
Mexico	1 671.9	1 585.3	1 350.0	1 415.4
Hong Kong (China)	751.0	824.8	792.6	890.3
Indonesia	437.6	397.6	466.3	571.1
Philippines	493.4	430.5	495.7	508.9
Viet Nam	5.1	134.8	456.8	460.6
India	326.6	344.9	376.2	412.2
Guatemala	348.0	315.5	342.4	391.7
Cambodia	204.1	249.0	362.9	390.4
Sri Lanka	269.4	285.7	318.3	359.0
(Kenya)	37.7	60.4	85.5	126.9

Source: USITC.

Aside from lacking backward integration, the Kenyan garment industry's competitiveness is hampered by the high cost and poor quality of infrastructure, and relatively high labour costs. Typical wages for a semi-skilled machinist in Kenya ranged from \$65-81 per month in 2003, compared with \$55 in the United Republic of Tanzania, \$73 in Lesotho, \$75-85 in Sri Lanka or \$110 in China, where productivity are also higher. The high cost of electricity and water and unreliability of service compared to major textile producers is also hurting competitiveness.

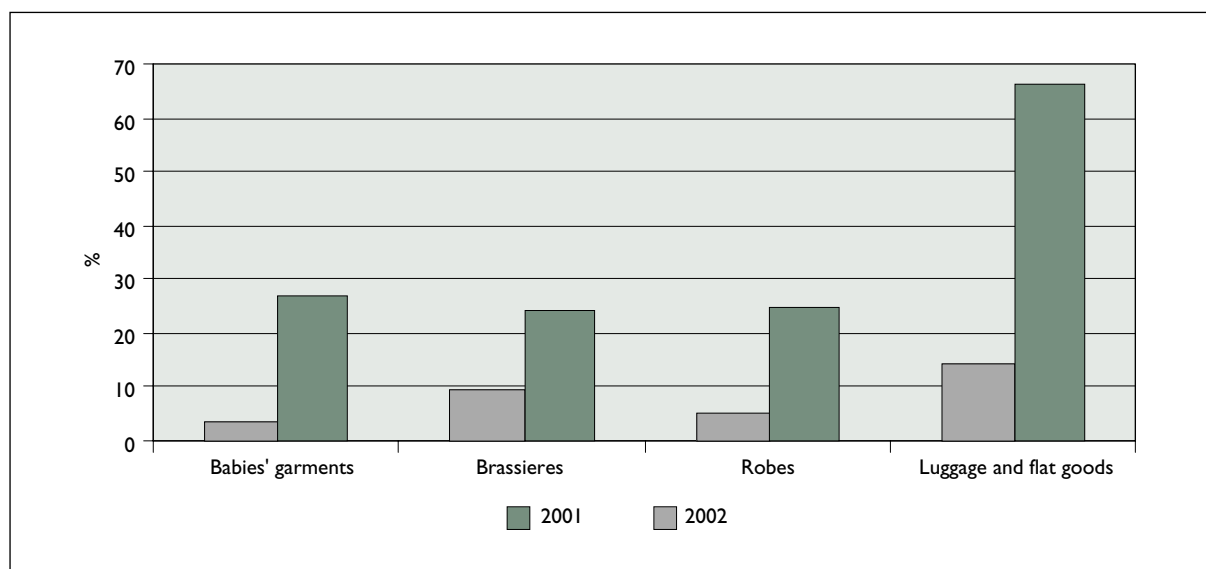
Table III.13 Top 10 Sources of US Imports of Men's or Boys' Suits, Ensembles, Trousers, Blazers, etc, Not Knitted or Crocheted (HTS 6203), 2001-2004
(Million dollars)

	2001	2002	2003	2004
Total	7 300.9	7 139.3	7 755.2	7 846.6
Mexico	1 898.5	1 944.4	1 903.0	1 836.1
Dominican Republic	810.1	822.1	800.6	692.5
China	367.6	358.6	461.5	602.7
Italy	334.2	325.2	361.4	360.7
Canada	287.0	299.0	343.1	330.2
Hong Kong (China)	286.1	265.1	254.0	294.4
Bangladesh	239.7	210.1	182.4	266.8
Indonesia	285.4	221.9	218.2	220.8
Viet Nam	1.2	89.0	302.4	217.3
Colombia	127.2	126.1	190.8	205.2
(Kenya)	21.1	32.5	39.9	61.6

Source: USITC.

A report from the USITC on global clothing and textile sourcing concluded that China is “expected to become the ‘supplier of choice’ for most US importers (the large apparel companies and retailers) because of its ability to make almost any type of textile and apparel product at any quality level at a competitive price” (USITC, 2004, p.xi). Its labour costs are low due to a combination of low wages and high productivity, and its quality is very high, such that it is “considered by industry [to be] among the best in making most garments and made-up textile articles at any quality or price level” (op. cit. p.xiii). As figure III.11 indicates, China's share of US imports has indeed grown very rapidly in those items where quotas were lifted.

Figure III.11 China's Share of US Imports Following Removal of ATC Quotas



Source: USITC.

In addition to investments in textile and clothing and supporting services, there were about 30 projects in EPZs as of 2004. The largest investment is from De La Rue Currency and Security Print, which produces currency and security documents. Other investments are mostly concentrated in agro-processing and chemicals

or pharmaceuticals. Both Kenyans and foreigners have invested in these sectors. In contrast, there have so far been few services investments in EPZs linked to the areas highlighted in section C, even though such services investments are allowed by the EPZ Act and benefit from all the incentives offered to producers of goods.

One significant exception is Kencall Ltd, a call centre that started operation at the end of 2004. The company was established by expatriate Kenyans with an initial investment in excess of Sh100 million (\$1.3 million). It started with 200 employees, most of whom are university graduates. The poor quality and reliability of telecommunication services forced the company to obtain a licence to set up its own satellite connection, and it was also forced to invest in a generator system to ensure continued operations in case of power outages.

2. Action Plan: Sustaining FDI in EPZs

The attraction of new foreign investors in garment manufacturing for export is a substantial achievement by the EPZA. The Authority is fully aware, however, how much the future of this industry in the EPZs depends upon attracting and retaining investment that is profitable in the absence of the types of preferential trade access as described above. For the reasons underlined above, there is a strong risk that Kenya's export-oriented garment industry does not have the structure and conditions needed to survive the removal of quotas under WTO rules as of January 2005 and the fabric-sourcing requirement under AGOA in September 2007. Given this strong risk, the EPZA should not rely on continued FDI to sustain the industry. Instead, the Authority and the Government as a whole should:

- Shift their attention, focus and resources *away from special efforts* to attract new FDI in textiles and garments;
- Prepare themselves for the possible disappearance of FDI in garments by setting up a strategy of diversification of FDI towards other manufacturing activities and services.

a. Shifting Focus Away from Garments

Government assistance to the garment industry should be confined to the *general* improvements in backbone services and industry competence that are recommended for application economy-wide. There is little merit or scope for additional *special* measures to attract FDI in the sector. There is no fiscal leverage given the extensive incentives already granted. It might be tempting to provide subsidies, but there is an undue risk that these would be costly and unsuccessful given the structural position of the industry. The Government and EPZA should certainly not discourage FDI in the garment sector, but their attention and limited resources should be dedicated to attracting sustainable FDI in other manufacturing sectors and services.

b. Diversifying the FDI Basis

The diversification strategy should be articulated around two axes: (1) diversifying FDI in manufacturing; and (2) attracting efficiency-seeking FDI in services.

Diversify FDI in manufacturing

As mentioned earlier, the Government has virtually no scope to provide additional fiscal incentives to attract efficiency-seeking FDI in EPZs. It is also difficult to identify niche export opportunities in manufacturing, and it is a task for which Governments lack competence. It would be more sensible in that respect to make full use of existing relationships and help current investors, especially in the garment sector, to develop new opportunities. A diversification programme targeting existing and new foreign investors could include the following components:

- Establish a dialogue with existing principals and managers to explore diversified investment opportunities.

- Provide incentives, including grants, for market research.
- Provide support for retraining of staff to apparel investors that diversify into other sectors. This could include a government-financed facility to train workers in relevant skills.
- Provide more liberal access to the Kenyan market than is currently the case for truly pioneering activities that do not compete at all with established domestic firms. Such an approach should be strictly limited to genuinely pioneering activities and be limited in time, as the export nature of EPZs must be preserved.
- Investigate innovative solutions for infrastructure improvements. These could include pooling company and EPZ resources for electric power back-up systems so as to minimize their cost.

Attract efficiency-seeking FDI in international services

The EPZ Act specifically allows investment in non-financial services activities, together with manufacturing. However, attracting services FDI in the zones has received less attention than manufacturing FDI. The EPZ structure nevertheless provides a useful and potentially attractive tool to complement the “regional services hub” strategy elaborated upon earlier.

The “regional knowledge hub” strategy seeks to attract mostly market-seeking FDI, with Kenya being a significant component of that market. Purely international services deal entirely with non-residents and Kenya must present itself as an efficient, tax-friendly location that is competitive on its merits with other offshore service locations. The EPZ structure could prove attractive to efficiency-seeking foreign investors, as the fiscal regime is extremely competitive with that in other emerging offshore service locations in Africa and elsewhere.

The following steps could serve as the basis for a strategy of attraction of efficiency-seeking FDI in services:

- Implement an investor-targeting exercise aimed at raising awareness among global services providers of the fiscal incentives, human resources and other strengths available through EPZs and in Kenya.
- The EPZA should specifically target call centre operators to explore the possibility of setting up in Kenya in order to benefit from a large pool of English-speaking and educated people, within a favourable time-zone for serving the European market.
- Support measures should be explored for pioneers in efficiency-seeking services FDI, particularly so as to lower the set-up cost of modern telecommunications infrastructure in an EPZ. Should interest arise from services providers needing initial investments in ICT, the Government should be particularly quick and flexible in providing the necessary licences to operate, including for setting up private international gateways.
- Actively promote the development of a cluster of services providers in one EPZ, where efficient telecommunications facilities (voice and broadband data) can be established so as to reap economies of scale.

Although the provision of financial services is not currently allowed in EPZs, the Government should explore whether it has the potential to build upon its well-regarded financial regulatory structure (Central Bank of Kenya and Capital Markets Authority), the presence of first-tier foreign banks (Barclays, Citibank, Standard Chartered) and recognized local skills to build a regional offshore financial services centre. This would require market research to establish whether Kenya possesses special competitive advantages either in sources of hard currency funding, or favourable tax treaty arrangements that could generate sizeable offshore deposits by non-residents.

G. National Private Sector Development and FDI

The strength of Kenya’s national private sector relative to its neighbouring countries is an asset the Government should build upon to attract foreign investors in search of efficient local suppliers. The objectives of fostering a strong national private sector, increasing the level of FDI and generating maximal linkages and knowledge

spillovers are complementary rather than contradictory. In the few sensitive sectors where crowding out of local investors by foreign investors may be an issue, this Review has recommended a *negative list* approach to restricting FDI entry (see section D, chapter II). In all other sectors, the Government should seek to optimize the complementarity between foreign investment and national investment through enterprise development and linkages programmes.

The competitiveness programme for manufacturing companies recommended in section C could go a long way in strengthening national enterprises. It could be part of a wider *Enterprise Kenya* programme, organized along the lines of the one that has been successfully operating in Uganda for the past three years with UNCTAD and UNDP assistance (box III.5). Such a programme would focus on providing hands-on support to existing and prospective national entrepreneurs.

Box III.5 National Private Sector Development: Enterprise Uganda

Enterprise Uganda was created in 2002 as an institution designed to support the Government in realizing its objective of fostering a dynamic national private sector. Its mission is to develop a new generation of Ugandan entrepreneurs by actively providing support to SMEs to enhance their productivity, growth and competitiveness. It works as a one-stop programme for existing SMEs and potential entrepreneurs and offers an integrated and comprehensive range of business support services, including:

- Entrepreneurship training workshops;
- Business health check;
- Business opportunity identification;
- Business counselling and advisory services;
- Preparation of business plans;
- Credit facilitation;
- Specialized consultancy and extension services;
- Client accounting and bookkeeping services;
- Sub-contracting linkages;
- Foreign linkage development;
- Management skills development;
- Assistance in developing joint ventures;
- Export market development.

The programme was established in partnership between the Government, UNCTAD and UNDP. Its hands-on approach has yielded significant results and allowed the creation of long-term relationships with client enterprises. It has touched companies in a wide range of sectors, from restaurants to travel agencies, cleaning services to consultancies, poultry farming to dairy products, garments assembly to electronics. It has also worked to promote linkages between TNCs and SMEs through supply chain developments.

Source: Enterprise Uganda, UNCTAD.

Linkages between large foreign investors and the national private sector tend to occur naturally when the latter is sufficiently developed, efficient and competitive. Government policies that promote efficiency and competitiveness of the national private sector are thus necessary for the sustainable development of backward and forward linkages. In contrast, more direct general measures to promote linkages are difficult to put in place. Local content requirements have proved in many cases inefficient and discourage FDI altogether. They are also contrary to certain WTO rules.

Focused linkages programmes that help TNCs and domestic companies (SMEs in particular) establish long-term business relationships have proved efficient in other countries, however. These programmes work at the company level and range from wider efforts to match TNCs with domestic businesses through “information exchanges” to more specific targeting of potential partners and actively approaching foreign affiliates. They seek to generate and help TNCs set up, among others: (1) linkages funds; (2) SMEs access to tenders and contracts; (3) facilitation of SME access to finance; (4) coaching, mentoring and evaluation of supply chains; (5) human resources development; or (6) development of modern management practices and compliance with international quality standards.

In addition to the *Enterprise Kenya* initiative, a specific linkages programme as implemented with UNCTAD support in other countries could be effective to maximize linkages between local SMEs and TNCs and other positive spillovers. In the services sector, the programme ought to focus at first mostly on tourism, retail, banking and finance, and telecommunications, given their natural potential for linkages.

In EPZs, the dominance of garment companies and the inability of local suppliers to compete with Asian fabrics in terms of cost, quality and reliability of supply have severely limited the linkages with the rest of the economy. Diversifying away from garment assembly and into other manufacturing and services investments should be the central element of a strategy to better integrate EPZs into the economy, given the unlikely prospects of creating an integrated textile supply chain. Other sectors, in contrast, could offer much more significant opportunities for local sourcing of inputs and value addition beyond the mere labour content.

Key elements of a strategy to maximize the linkages between EPZs and the economy would entail:

- Having the EPZA establish a specific linkages programme;
- Facilitating the remission of import duties in case of sales to EPZs by domestic firms;
- Providing more liberal access to the Kenyan market for truly pioneering activities so as to favour forward linkages;
- Using EPZs as a "testing ground" for new policies. This would be especially useful in the telecommunications sector, particularly in terms of providing infrastructure for international communications. Successful experiences in EPZs could later be built upon and extended to the economy as a whole.

H. Note on Implications for Investment Promotion

The strategic focus advocated in this Review will require decisive actions and a change in perspective by the authorities with respect to opportunities for (and threats to) growth and FDI attraction. It is particularly important that the opportunities in services and the policies needed to achieve the growth and FDI potential of the sector be recognized at the highest level of authority, and throughout the Government. In that respect, the role of the NIC in instilling a medium- and long-term strategic vision of development and FDI attraction will be critical.

By request, this report has not reviewed the mandate or activities of the investment promotion agencies. If the strategic agenda recommended here were adopted, however, it is worth noting that some adjustments in activities and focus of KIA and the EPZA would follow. In particular:

- The advocacy role of KIA would need to be strengthened in relation to: (1) the improvement of backbone services, including by way of benchmarking infrastructure services with respect to South Africa initially, and then globally; and (2) the fine tuning of the tax and regulatory regime, with particular regard to promoting FDI in regional services.
- This advocacy role should be at least as important as the attraction roles in the near term. A significant push forward in attraction FDI in international services, however, would require a high-powered attraction campaign.

- KIA and EPZA both need to make a significant effort in aftercare services in order to encourage existing investors to maintain or expand their presence in Kenya. This function will be particularly important: (1) for the EPZA in order to help garment investors to diversify; and (2) for KIA to bolster Kenya's sagging performance in basic manufactures exports to the regional market.
- KIA's investment promotion and targeting strategies should integrate systems to advance FDI opportunities across the different regions of Kenya. While many of the investments in manufacturing and in the provision of services to East Africa are likely to be focused on the Nairobi and Mombasa areas, significant opportunities exist for FDI to contribute to development outside the main urban areas, particularly in tourism and agri-business.

IV. MAIN CONCLUSIONS AND RECOMMENDATIONS

Kenya has dramatically underperformed in attracting FDI over at least the past two decades. This was the consequence of increasing corruption and insecurity, deteriorating infrastructure and poor economic policies, rather than of formal restrictions on FDI entry. Surprisingly, however, Parliament put in place such formal entry restrictions at the end of 2004, overturning decades of openness to foreign investors.

In spite of the poor economic performance of the past decades, Kenya remains a regional business leader and retains regional advantages in FDI location, particularly as a result of the quality of its workforce and a central logistics position. In contrast, global shifts in manufacturing production, and to a lesser extent services, from the developed to the developing world are passing Kenya by, as illustrated by its failure to attract new and dynamic FDI. Far from benefiting from these FDI-led global shifts, the evidence is that Kenya is losing ground as potential foreign investors stay away from the country and existing investors relocate elsewhere.

There have nevertheless been welcome bright spots, such as the rise of internationally competitive floriculture and horticulture, and the success of Kenya Airways in transport and logistics. In contrast, it is most uncertain whether the size and quality of current FDI in garments will ensure long-run competitiveness and sustainability. Additionally, Kenya's position in the production of basic manufactured goods for the region has been eroding and is not being sufficiently supported to meet the competitive threats or to grasp opportunities.

Kenya does not currently have a genuine strategy to harness FDI to aid national development. On the contrary, the recent Investment Promotion Act imposes unnecessary new barriers to FDI that will more than offset the possible gains of new incentives offered under the Act. If Kenya were to succeed in attracting as much FDI per unit of GDP as developing countries on average in 1996-2003, inflows would be sustained at \$400 million a year, over ten times the average in 1996-2003. A strategy to attract such types and levels of FDI inflows and maximize their developmental benefits should contain four elements:

- Improving the dynamic determinants of FDI;
- Providing a competitive and efficient investment framework;
- Targeting high potential investment opportunities for special regulatory attention and investor promotion;
- Gearing government agencies for effective investment promotion.

A. Improving the Dynamic Determinants of FDI

Investors cross borders to access markets or resources, or gain efficiencies. These fundamentals are determinants of FDI attractiveness. Not all of these endowments are fixed. Long-term government action can change them and the scope is widening as global FDI increasingly targets manufacturing and services rather than natural resource endowments.

This review finds that Kenya has a mixed record in FDI determinants. It can be proud of its long-standing attention to general education and the development of human capital. The "quality of people" has been a bedrock of the competitiveness of export floriculture and horticulture. It has enhanced national benefits by enabling foreign investors to partner local producers and export to exacting markets. The Government's commitment to human development seems set to continue and this could underpin efficiency-seeking FDI.

Unfortunately, these qualities have not been translated into continuous modernization of competence in manufacturing. Conditions have not encouraged sustained private investment and there is currently a crisis in basic manufacturing. The situation warrants government support for a manufacturing competence-building programme to help local companies and improve the sector's profile for future FDI. On the positive side, the Government has been active in regional and other trade agreements, which enhance market size for investors

locating in Kenya. Work still needs to be done on ancillary arrangements –in trade, tax and services– within the East African Community and with other neighbouring countries.

Lack of public investment and/or poor policies have led to the neglect of infrastructure and failure to ensure that backbone services –utilities, telecommunications and transport– are provided on a competitive basis. The resurgence of Kenya Airways following its privatization is an indication of the opportunities that have been lost to engage FDI in upgrading Kenya’s competitiveness. Kenya should note that FDI in export manufacturing and lately in specialized international services is increasingly won (or lost) by the efficiency gains that host countries can offer foreign investors. Kenya has modernized legislation to enable key services to benefit from competitive private investment, but this has not been followed through in securing that investment. Importantly, there is much that can be done by the Government in these matters without overspending. Private investment, including world-class FDI, can be attracted in the right conditions to improve backbone services and infrastructure and to contribute to industrial modernization.

B. Providing a Competitive and Efficient Investment Framework

The review finds that Kenya’s investment framework is generally sound on paper. There are outstanding features including the absence of foreign exchange controls and a moderate and professionally administered taxation system. While some of the commercial legislation is rather dated, and should be modernized in due course, it is workable and does not by itself impede the attraction of FDI or its capacity to benefit the Kenyan economy.

On the whole, the targets for legislative modernization over the last 10-15 years have been appropriately targeted, and the pace of legal reform has been reasonable. This includes legal reforms to liberalize telecommunications, electricity and airports, and to safeguard competition, the environment and intellectual property rights. The unsatisfactory aspects and impediments to investment have been the poor quality and probity of administration of business regulation and commercial justice, and, as noted above, the failure to engage private investment fully into the backbone services, which remain liberalized on paper only. Even where some current services remain in government ownership it should be made possible for the private sector to offer parallel services.

Thus the remaining programme of “must do” general regulatory reform is relatively short and could be accomplished in about 12 months. It is articulated around two parts: (1) five Acts to introduce or change; and (2) four areas in which proper regulations and/or policy statements would reduce the uncertainty for investors and the scope for undue discretion and corruption by officials. In addition, the investment promotion targets would entail some tax and regulatory change as discussed later.

I. Legislative Amendments

First and foremost, legislative changes should centre on an urgent review of the FDI restrictions recently introduced, focusing on the original intention to facilitate investment. The Government has taken a crucial step in that direction by sending proposals for amendments to the Investment Promotion Act to Parliament. This would remove the compulsory registration of foreign investments and lower the threshold for eligibility to *optional* investment certificates (and related special incentives) to \$100,000 from \$500,000. The key Acts to introduce, change or repeal are:

- The Investment Promotion Act;
- The Privatization Act;
- The Kenya Ports Authority Act;
- The Restrictive Trade Practices, Monopolies and Price Control Act;
- The Mining Act;
- The Trade Licensing Act.

2. Regulations and Policy Statements

Clear guidelines and policy statements are essential in order to make the current system work better for investors by increasing predictability and reducing discretionary powers. The key policy statements and regulatory guidelines to be formulated concern:

- The transfer of rural land to foreigners;
- The allocation of undeveloped agricultural and government land;
- Work and residence permits;
- Transfer pricing.

Major improvements in the efficiency and transparency of business administration and commercial justice and in personal and property security are also imperative if Kenya is to achieve its potential to attract and benefit from FDI. The current Government was elected to tackle corruption and receives reminders about this, and no little support, from donors. Progress on these matters is central to executing a successful FDI strategy.

C. Targeting High Potential Investment Opportunities

Actions to influence the dynamic determinants of FDI and to improve the investment framework are the *foundations* of an FDI strategy. The key opportunities to be pursued are the *pillars* of the strategy. The review finds that Kenya should focus on four pillars. These pillars should be receive specific tax and regulatory changes as required, should influence thinking on the programmes to improve the dynamic determinants of FDI and should attract the lion's share of proactive campaigns of investor targeting, facilitation and aftercare.

1. Pillar 1: Basic Manufactures for the Regional Market

A strategy to strengthen Kenya's position in the production of basic manufactured goods for the regional market would include:

- Setting up a proactive tax and regulatory stance, including: (1) efforts to enhance market access through regional trade agreements; and (2) a lower tax rate on foreign source income;
- Putting in place a comprehensive programme to introduce world-class manufacturing concepts to the manufacturing sector. This would entail: (1) an awareness programme funded by the Government; (2) a sectoral and firm-specific benchmarking programme, partly funded by the Government; and (3) the establishment of learning networks, aimed at better integrating supply chains and favouring linkages between domestic suppliers and foreign investors.

2. Pillar 2: Kenya as a Regional Services Hub

Although the Government has given little or no strategic priority to the promotion and development of Kenya as a platform for the provision of services to the region, it has key comparative advantages that could be strengthened by the following measures:

- Lifting minimum capital requirements for FDI. This is a *sine qua non* for the development of Kenya as a regional services hub through FDI. Other measures will remain largely ineffective until that condition is met.
- The services sector should be put at least on as favourable a footing as the manufacturing sector for tax purposes, and renewed attention must be given to specific issues. Recommendations include: (1) lower the corporate tax rate on foreign source income; (2) provide unilateral relief from double taxation of income; (3) conclude additional DTTs and strive to reduce services fee withholding taxes in the treaties; and (4) extend "investment deductions" available to the manufacturing sector to the services sector.

Box IV.1 Kenya Commits to Reforms Under UNCTAD/JBIC Bluebook Initiative

President Mwai Kibaki committed Kenya in June 2005 to speedy implementation of nine key measures to improve the investment climate. These closely follow the key measures and recommendations of this Review and consist of:

- Lifting the compulsory screening of FDI and minimum capital requirement;
- Reviewing the process of awarding work permits;
- Introducing deadlines and penalties for excessive delays in the payment of VAT refunds by the KRA;
- Introducing guidelines for transactions in agricultural land;
- Establishing a performance benchmarking project for the manufacturing sector;
- Establishing a business linkages project involving at least 10 major TNCs;
- Jointly issuing business visas for travel to EAC member States;
- Bringing into force the EAC treaty on double taxation;
- Developing investor-tracking and aftercare capacities at KIA.

These measures were proposed by UNCTAD and JBIC in a *Blue Book on Best Practice in Investment Promotion and Facilitation* and are concrete actions that can be implemented over a period of 12 months and easily monitored. They reflect the concerns of investors and stakeholders, who were consulted throughout their elaboration.

- Improve access to the regional market by advancing preferential trade agreements in services. Priority should be given in that respect to the EAC, before COMESA. Trade-enhancing measures should include mutual recognition of qualifications for professionals, more accommodating immigration and labour market regulations, and removing barriers through professional licensing requirements.
- Ensure that the best human resources are available to investors, including through a more flexible approach to granting foreigners work permits.

3. Pillar 3: Reinforcing the Agri-Business Success

Horticulture and floriculture have thrived in recent years as a result of a dynamic private sector. The Government should nevertheless consider indirect policies to support the sector and improve operating conditions, paying particular attention to suggestions from horticulture and floriculture companies. Operating conditions would benefit from:

- Improved road and airport infrastructure in the main growing areas;
- Improved access to agricultural land for foreign investors;
- Ensuring that the CAA obtains certification from the US FAA so as to allow Kenya Airways to operate direct air links with the United States if it wishes to do so, hence offering cargo space for direct export of fresh produce to the United States.

4. Unconfirmed Pillar 4: Diversification of FDI in EPZs

Investments in garments manufacturing for exports are under threat as a result of global changes in trade policy and competition. Given this threat and the absence of additional fiscal leverage to attract FDI in EPZs, Kenya should not rely on continued FDI to sustain the industry. Instead, the EPZ Authority and the Government should:

- Shift their attention, focus and resources *away from* attracting FDI in textiles and garments.

- Prepare themselves for the possible disappearance of FDI in garments by setting up a strategy of diversification of FDI towards other manufacturing activities and services.

A diversification strategy away from garments FDI in EPZs should include:

- Diversify FDI in manufacturing, including through: (1) establishing a dialogue with existing investors to explore diversification; (2) providing incentives, including grants for market research; (3) providing support for retraining of staff; and (4) providing more liberal access to the domestic market for genuinely pioneering activities that do not compete with established domestic enterprises.
- Attract efficiency-seeking FDI in services, including through: (1) a targeting exercise aimed at raising awareness of EPZ incentives among major international services providers; (2) target call centre operators; (3) provide easy access to international gateway licences for telecommunications; (4) establish high-quality ICT services in at least one zone, probably Athi River; and (5) actively promote a cluster of services providers in a single zone to reap economies of scale.
- Explore the possibility of developing an offshore financial services centre through appropriate legislation to complement the EPZs, which cannot serve as a basis for financial services.

D. National Private Sector Development and FDI

A strong, efficient and competitive national private sector is an important element of FDI attractiveness. It is also a key determinant of the extent to which linkages between TNCs and the local economy, knowledge spillovers and other benefits from FDI are generated. Aside from a programme to introduce world-class manufacturing in the manufacturing sector, the Government could thus foster national private sector development and linkages through:

- An *Enterprise Kenya* programme aimed at providing hands-on support to existing local SMEs and prospective entrepreneurs. A special institution would work as a one-stop shop to provide business support services ranging from health checks to business counselling, credit facilitation, export market development, bookkeeping or management skills development.
- A linkages programme aimed at maximizing linkages between local SMEs and TNCs and other positive spillovers from FDI.

E. Gearing Government Agencies for Effective Investment Promotion

This Review was not aimed at evaluating the investment promotion agencies. Accordingly, no assessment has been made of the mandate, performance and resources of the agencies in the light of its overall findings. It suffices to note some obvious implications:

- The newly created NIC should take a strong leadership role in improving investment policies. It should take responsibility for implementing and monitoring progress on a specific 12-month agenda such as suggested above.
- In particular, it should immediately draw up a shortlist of priority policy actions to be implemented in the short term, and monitor implementation.
- The advocacy role of KIA would need to be strengthened in relation to: (1) the improvement of backbone services, including by way of benchmarking infrastructure services with respect to South Africa initially, and then globally; and (2) the fine tuning of the tax and regulatory regime, with particular regard to promoting FDI in regional services.
- This advocacy role should be at least as important as the attraction roles in the near term. A significant push forward in attraction FDI in international services, however, would require a high-powered attraction campaign.
- KIA and EPZA both need to make a significant effort in aftercare services in order to encourage existing investors to maintain or expand their presence in Kenya. This function will be particularly important:

- (1) for the EPZA in order to help garment investors to diversify; and (2) for KIA to bolster Kenya's sagging performance in basic manufactures exports to the regional market.
- KIA's investment promotion and targeting strategies should integrate systems to advance FDI opportunities across the different regions of Kenya. While many of the investments in manufacturing and in the provision of services to East Africa are likely to be focused on the Nairobi and Mombasa areas, significant opportunities exist for FDI to contribute to development outside the main urban areas, particularly in tourism and agri-business.

ANNEX I: METHODOLOGY OF INTERNATIONAL TAX COMPARISONS

The Comparative Taxation Survey compares taxation on investment in several sectors in Kenya with taxation in other selected countries – neighbours and countries elsewhere that have succeeded in attracting FDI to the sectors concerned. These comparisons enable Kenya to assess the competitiveness of its taxation.

Taxation affects the cost of investment and its profitability, and thus the return on investment. This impact is not just a question of looking at the headline rate of tax on profits. The tax burden on the investor depends on a number of factors and their interaction, including expenses allowed, rates of capital allowances (tax depreciation), the availability of tax credits, investment allowances and tax holidays, the loss-carry-forward provisions and the taxation of dividends among other things. Moreover, customs tariff and excise duties affect the cost of investment and operating margins. Together these make up the overall fiscal regime that affects the cost of and return on investment.

Comparative tax modelling is a method of taking into account the most important of these variables in the fiscal regime in a manner that facilitates comparison between countries. The tax variables included in the analysis are:

- Corporate income tax;
- Rate of tax including tax holidays, if any;
- Loss-carry-forward provisions;
- Capital allowances, investment allowances and investment credits;
- Tax on dividends;
- Customs import duties and excise duties on business inputs.

VAT and sales tax are not considered in this analysis.

Financial models of project investment and financing, revenues and expenses are utilized for a hypothetical business in each sector. These are based on typical costs and revenues experienced in such businesses in a developing economy. The business models cover a selected business within each sector.

The fiscal regime in Kenya and the chosen comparator countries for each sector is applied to the standard business model for each sector over 10 years beginning with the initial investment. The financial models calculate net cash flow to the investor, assuming that the company pays out all residual profits after tax (100 per cent dividend pay out) and that the investor gains the residual value of the company, which is sold after 10 years for an amount equal to its balance sheet value.

The impact of the fiscal regime is presented as the *Present value of tax (PV tax per cent)*. PV tax per cent is the total of taxes and duties collected by government over the 10 years as a percentage of the project cash flow pre-tax and post-finance where both cash flows are discounted to a present value at a rate of 10 per cent per annum. PV tax per cent thus measures how much of an investor's potential project return is taken by the Government in taxes and duties. The higher the PV tax per cent, the more the fiscal regime burdens investors and reduces the incentive to invest.

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