

*Unleashing The Entrepreneurial Potential of Micro and Small  
Enterprises in Kenya : Some Experiences and Directions*

**A Thematic Working Paper  
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**The views expressed in this paper are those of the author and  
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## EXECUTIVE SUMMARY

**This paper outlines the challenges the poor and disadvantaged in Kenya face in accessing opportunities in the formal economic system and some solutions being designed. It summarizes what still remains to be done and underlines the role of public private partnership. It begins with the recognition that most of the poorer Kenyans earn a living in the informal sector without easy or full access to the advantages of formal financial and business support systems. Examples illustrate that the two economic sectors, formal and informal, do not exist independently of each other. There is overlap and exchange between them but this tends to be of an ad hoc nature and not in the form of sustained business linkages. Kenya's profile of enterprises is dominated by Micro and small enterprises (MSEs) found in both the formal and informal sectors. The informal sector created almost all the new jobs in the country last year. In 2006, employment in the informal sector was estimated at over 6 million persons in comparison to formal sector wage employment estimated at just under 2 million <sup>1</sup>.**

**Institutional innovation in terms of business linkages between the formal and informal sectors is being facilitated by donor-subsidized NGOs. There are exciting results in terms of income and skill enhancement at the level of the small farmer. Questions on replicability and scaling up methods are still largely unanswered. Through pilot projects small producers in rural areas and urban based microenterprises are being linked to the larger processing, export and manufacturing firms. Risk mediation is being done again by NGOs. The biggest problem that formal large businesses have experienced in purchasing supplies (of agricultural produce) and finished products from the MSEs is the lack of consistent quality and adequate quantity. Capacity development and quality control initiated in some sectors by NGOs has had a demonstration effect. Some private sector players are offering embedded services for capacity development of their suppliers through outsourcing arrangements.**

**The realization of the potential of informal MSEs is constrained in by shortages of cash and appropriate technologies and skills and poor access to markets. Production and sales are often located in makeshift premises under constant threat of eviction. Financial and civil society institutions are working to support such business activities but their reach is still quite limited. Microfinance institutions are successfully using social collateral to offer financial services to the poor and show high repayment rates. NGOs are working with financial institutions to develop innovative mechanisms for mediating financial risk.**

**The private sector comprised of the agriculture, trade, manufacturing and service sectors has a broad base of small producers who are often not aware of their market location and its potential. The foundation of awareness creation, information and skill enhancement is being done mostly by civil society organizations ranging from large producer associations to community based organizations. Public sector**

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<sup>1</sup> Government of Kenya, *Economic Survey 2006*, The Government Printer, 2006, Nairobi.

**officials in the rural areas work closely with such agents of community mobilization but there is still very limited impact. This is particularly true of the northern districts of Kenya where the pastoralist people live. Lack of infrastructure and years of policy neglect have essentially kept them outside market structures.**

**To improve the business environment for all enterprises, licensing reform is being undertaken. Over a thousand licences affecting businesses are being closely reviewed. Some licences have been abolished and several others are earmarked for the same over the coming months. Current legislation allows local authorities considerable discretion in the licensing of small-scale business activity. This is where petty corruption has been pervasive adding to the costs of the informal entrepreneur. The revision of local government bylaws has been identified as a priority.**

**Over the last four years, two new policies of importance to the MSE sector have been drafted. In 2005, Sessional Paper No. 2 laid out the policy framework for support to MSEs. In it, the government recognizes MSEs as dynamic private sector players and not a residual sector. It expands the previous definition of the term MSEs (as denoting non-agricultural enterprises) to include farm based enterprises as well. There is a provision in the Paper for 25% of public procurement to be allocated to MSEs. The Paper also proposes the establishment of a National Council for Small Enterprises to advise on the sector and to fundraise for its capacity development. The sessional paper (a policy document) however has yet to be drafted as a Bill and enacted as an Act of Parliament. Meanwhile the Kenya Private Sector Alliance, an umbrella body for the larger players in the formal sector, has been charged by the Ministry of Labour to design an implementation framework for some sections of the Paper. This relates to the development of a viable institutional structure for self-regulation of the MSE sector.**

**The other piece of pending legislation is the Microfinance Bill which is currently before Parliament. It lays out the regulatory framework for MFI operations. In order to move them towards sustainability, MFIs will be licensed as deposit taking institutions and therefore will have to be supervised or regulated by the Central Bank of Kenya. While there are fewer than 10 MFIs which are considered to have sound governance structures and organizational processes, there are several thousand savings and credit cooperative organizations (SACCOs) serving both rural and urban households. They too will be streamlined through the proposed SACCO Bill. While two banks are opening up to the delivery of financial products to small businesses, their experience is as yet undocumented. MFIs are deepening financial markets but still mainly accept existing credible businesses as clients. Credit for business startups remains problematic for MSEs. Here community and NGO-managed revolving funds and private sources remain the main but inefficient vehicles of delivery.**

**The Ministry of Trade and Industry has recently drawn up a Private Sector Development Strategy. One of its objectives is the enhanced competitiveness of**

medium, small and micro enterprises through increased vertical linkages. Sector specific capacity development is proposed. Other objectives relate to improving the business environment and labor market institutions and processes.

Organizational and group development at the level of local communities is sorely needed in both the urban and rural areas. Thousands of community based associations exist all over Kenya to serve the welfare and financial needs of the poorer Kenyans. Across them all, problems of accountable and transparent governance are a daily challenge. Fiscal discipline and organizational strength in producers' groups is an essential premise to the greater involvement of the poor in the formal economic sector.

Active development of markets for both financial and non-financial services and the development of capacities to demand and supply services is also vital. Whereas in the industrialized countries, State subsidies might be offered for such capacity development, in Kenya, as in much of Africa, these are provided by donors through their support to NGOs. The strengthening of social capital in the form of groups operating as market players is at the heart of the institutional experimentation underway in both urban and rural areas.

Those particularly disadvantaged in the marketplace are the youth, women and the pastoralists. Kenya has a youthful population - 75% of Kenyans are below 30 years of age. Almost seventy per cent of those unemployed are youth; majority of them have no vocational or professional skills.<sup>2</sup> The Ministry of Youth has announced a Youth Enterprise Fund to be delivered through competitive bidding by NGOs. Youth representatives have already voiced cynicism about how the Fund might be disbursed but show enthusiasm for business and want to learn about available opportunities.<sup>3</sup>

Women own at least 48% of Kenya's microenterprises most of which are in retail trading. They hold titles in their own names to only 1% of the land. Five per cent of land is owned by women jointly with men. Women's status with regard to land ownership contributes to their limited access to credit for businesses beyond the micro and small levels. Moving into value adding and manufacturing entrepreneurship is also constrained by limited technical skills and market information and the double burden of their productive and reproductive roles. Most women work with family members out of home based enterprises but as savings accumulate, some are venturing into growth-oriented businesses in services such as transport and tourism.

The pastoralists refer to their livestock assets as their wealth, their insurance and the determinants of their status. But livestock usually does not count as viable collateral for credit from financial institutions. NGOs are offering revolving funds

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<sup>2</sup> Youth interventions at the International Youth Summit held in Nairobi, September , 2006.

<sup>3</sup> Statistics from the Ministry of Youth, the Government of Kenya, 2006.

**to create livelihood diversification and increasing commercialization in these areas so that market structures are more inclusive of the hard-to-reach areas where the pastoral people are. But these efforts are still very small compared to the urgency of the need in face of increasing vulnerability to drought and diminishing access to dry season grazing resources.**

**Risk mediation is a fundamental concern in making markets more inclusive of the poor. Formal institutions and firms both large and small are essentially risk averse in the absence of adequate investor protection or social safety net. So far, this mediation between large and small businesses is provided by guarantees through contractual and financial arrangements facilitated by credible intermediaries such as donors and NGOs. The Government's new Private Sector Development Support Strategy and the value chain approach proposed could also offer new methods of support through value chain financing supported by private and public players in that chain. This could translate into more opportunities for the poor to be involved in the formal sector and its markets.**

**If requisite macro level changes are to occur and sustain, the government must attempt to ensure a more level playing field in the global marketplace. It should offer Kenyans some of the subsidies their competitors in neighbouring countries do. It should actively develop regional trade agreements so that formal sector markets can grow and MSEs can get a share of the benefits of growth. Kenya has no shortage of pilot projects which show increases in the incomes and the asset base of hundreds of informal entrepreneurs. Each has facilitated some degree of formalization of the business status usually through some form of licensing and status documentation and connected small producers to high volume or high value markets. The lessons from these pilots have to be adapted to different local situations and success scaled up to encompass millions of such entrepreneurs. Change has begun. Deregulation, deepening of markets, legal vigilance and supportive institutional reform also must continue and resources for this be made available.**



## **1.0 Introduction**

**Kenya's private sector (agriculture, industry and services) accounts for 81% of the GDP and provides more than half of formal wage employment.<sup>4</sup> It is the informal sector and the MSEs in it which have created almost all of the new jobs in Kenya's economy last year. The formal and informal economic sectors overlap and exchange skills and products but most of the informal MSEs still show low and insecure incomes for its owners and employees. Most MSEs are disadvantaged private sector players; current relationships within the private sector must change for more productive business interaction. This requires opening up of access to formal financial and non-financial services, a process of education and capacity development of the smaller businesses and above all, trust building between the larger firms and their smaller suppliers and marketers. All this requires active facilitation and resources.**

**This paper reflects on how the poor can have more opportunities to establish businesses. It describes how barriers such as complex business regulations and financial constraints are being and can be further addressed so that marginalized men, women, youth, slum dwellers and pastoralists can engage in profit making businesses more easily.**

**The five sections which follow describe the predominant role of MSEs in the Kenyan economy and what currently supports or constrains their upward mobility and further integration into the formal economy. They describe changes underway in the regulatory environment, some institutional innovations and market development efforts. The final section points out some policy principles and directions for multifaceted and sustained support to entrepreneurship.**

## **2.0 The Present Situation**

### ***2.1 The Macro Context***

**At the macro level, Kenya is making strides. In 2005 Kenya recorded an economic growth of 5.8%. Production and exports of some of the firms have more than doubled in the last three years. The national budget for the first time in Kenya has low dependence on donors. If the private sector could be guided towards robust business linkages between different levels of enterprise, both MSEs and the larger firms would benefit within a growing domestic and regional markets. A real difference could be made to poverty levels in this country. But so far the improved economic climate has not translated into any visible reduction in poverty. More than**

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<sup>4</sup> Government of Kenya, *Economic Survey 2006*, The Government Printer, Nairobi, 2006.

half of Kenya's population, 57%, continue to live below the poverty line.<sup>5</sup> This is equally true of both the rural and urban areas.

The *Economic Survey 2006* recognizes the plight of the poor:

the first quarter of 2006 witnessed increases in prices of some food commodities due to drought during the fourth quarter of 2005. Prices of vegetables more than doubled while fuel prices remained on an upward trend.<sup>6</sup>

A contributing factor is the current inflation rate which has recently been between nine and ten per cent and climbing. Unless this can be curbed, the poor will continue to struggle to purchase essentials. A London-based think tank, the Economic Intelligence Unit (a member of the Economist Group) predicts that the inflation rates will decrease together with an upward trend in GDP growth. The EIU report also notes that ongoing investment in infrastructure, transport and telecommunications will keep contributing to the creation of a much improved business environment over the next few years. The Government recognizes that for the poverty levels in the country to be affected in a positive way, the inflation rate must be brought down to below five percent.<sup>7</sup>

Small beginnings towards more positive policy directions and greater integration and less fragmentation of the economy are being made. Until now policy and donor support have tended to focus mainly on supply side issues paying attention to technical and financial assistance rather than fundamental issues of market development within a cohesive economic framework. Attention to developing markets for microfinance, business services and through these inputs for improved MSE products, is very recent.

The growth or decline of individual MSEs has also to be seen within the context of an economy where 50% of installed industrial capacity is underutilized.<sup>8</sup> Reasons given by some manufacturers range from the economic decline of the past decades to the fact that hopes for an East African and regional markets have not fully materialized<sup>9</sup>. Continuing conflict in neighbouring countries of Sudan, Somalia and further across to the Congo has meant industries poised to reach new consumers in these countries have not been able to. A constrained large firm sector has obvious implications for business linkages with the small firms.

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<sup>5</sup> Kimalu P. et al, *A Situational Analysis of Poverty in Kenya*, KIPPRA Working Paper No.6, Kenya Institute for Public Policy Research and Analysis, Nairobi, 2002.

<sup>6</sup> *The Economic Survey 2006*, GoK, 2006.

<sup>7</sup> Mbara J., "Kenya to Enjoy a Good Run of Economic Growth : Report", *The Sunday Nation*, October 1, 2006.

<sup>8</sup> The extent of underutilization was estimated in a presentation by David Nalo, the Permanent Secretary , the Ministry of Trade and Industry, 31<sup>st</sup> August 2006.

<sup>9</sup> Reasons as stated in this sentence and the following are from the author's conversation with a member of the Kenya Association of Manufacturers.

While all four levels of enterprise - micro, small, medium and large - reflect ample entrepreneurial initiative in Kenya, the onus of channeling their energy towards a clear focus on an integrated and a regionally and globally competitive economy lies largely with the government in its facilitation role. In an enabling environment, businesses themselves can step forward into the market to meet the business inputs and service needs of levels of enterprise above and below their own levels and together position Kenya's comparative advantage in regional and global markets. The newly developed Private Sector Development Strategy promises support to a value chain approach to economic development linking entrepreneurial activity at all levels.

## *2.2 Most Kenyan enterprises are informal MSEs*

The 2005 Sessional Paper No. 2 on the Development of MSEs for Wealth and Employment Creation for Poverty Reduction defines MSEs as all enterprises which employ from 1 to 50 workers. This includes small scale farms. Previously MSEs have been defined as all off-farm enterprises employing 1-50 workers.

This section draws on data from the 1999 national baseline survey of Kenyan non-agricultural MSEs. At that time, MSEs were contributing 18.4% of the Gross Domestic Product, more than double the contribution of the larger formal manufacturing enterprises. Survey findings showed that :

- Over 95% of Kenyan enterprises are microenterprises employing 1 to 10 employees.
- Many of these are located in the informal sector.
- Microenterprises have a high mortality rate and most do not survive beyond three years of operation.
- Women own half of Kenyan MSEs
- More than 60% of the MSEs are in small towns and rural areas
- The average number of employees in a Kenyan MSE is 1 or 2.

Engaging in MSEs is not a full time occupation for all of the owners or employees but instead provide a seasonal or additional income. Microenterprises comprise over 90% of the MSEs and most are located in the informal sector. MSEs in the informal sector can be either unlicensed or licensed to conduct an income generating activity but not registered as a business. Informality does not imply illegality. Kenya's informal enterprises are essentially "unincorporated enterprises".<sup>10</sup> There is what might be termed "a progression of legality" among the MSEs in their varying levels of adherence to licensing, registration and legal requirements of doing business. But even though licensed, microenterprises such as food kiosks, street traders, repair booth operators in urban areas are subject to period "official swoops" which remove them and relocate them away from their existing locations.

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<sup>10</sup> Central Bureau of Statistics, ICEG and K-Rep, *National MSE Baseline Survey 1999*, Nairobi, 1999.

**This has a palpable effect on their sales and profits. It also raises the question of defining what is perceived as an informal activity even when formally licensed.**

**The definition of informal sector as outlined in the 1972 ILO Mission no longer fully applies to Kenya's informal sector. In fact almost all of the criteria used to distinguish informal from the formal sector is no longer entirely true. What remains characteristic of informal activities is that they are 'unprotected'.<sup>11</sup> This observation in the mid-seventies by Dipak Mazumdar was very astute. Mazumdar noted that the main distinction between the formal and the informal sectors was that informal sector employers and employees were not protected by legislation on minimum wages, labour protection and social security. However, in Kenya, although the formal sector enterprises are required to offer this protection to their workers, in fact many formal sector enterprises also do not adhere to the labour laws or respect regulations on working conditions.**

**A criterion that clearly distinguishes informal from the formal medium or large enterprises in Kenya is that informal enterprises have mostly local distribution channels and markets. Informal enterprises because of their many constraints often cannot sustain the quality and quantity of their products over any specified period and so their products are usually distributed and consumed locally responding to the local consumption and personal service demand (transport, catering, personal services such as hairdressing, cleaning etc.).**

**The economic role of MSEs is fully recognized in the *Economic Recovery Strategy (ERS) for Wealth and Employment Creation 2003-2007*. The ERS states :**

**The large majority of Kenyans outside small-scale farming derive their livelihoods from micro and small enterprises (MSEs) both formal and informal. Since the mid-90s, MSEs have created virtually all the new wage jobs in the economy.**

**The Structural Adjustment policies adopted in the 1990s and the parallel decline in the economy contributed significantly to the growth of the size of the informal sector. It has continued to grow and is finally beginning to get some of the policy attention it deserves. Regulatory and policy reform is outlined in Section 3.**

### ***2.3 The Informal - Formal Overlap***

**Small informal clusters, which engage in manufacturing in terms of tailoring, metalwork and carpentry are emerging as semi-organized entities in both the urban and rural sectors. Their business relationships are mostly with other MSEs and local markets but all have some linkages vertically with larger businesses. For example, many manufacturing firms use storage containers fabricated by the MSEs while in agro-based industries, it is the small producers who supply the bulk of produce to be processed. Several of the informal MSEs' production inputs are sourced from the larger formal enterprises.**

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<sup>11</sup> Mazumdar D., "The Urban Informal Sector", *World Development*, No. 4, 1976.

The example of city - based Jua Kali<sup>12</sup> sheds where small fabrication of metal and wooden products is done also present a vivid picture of the formal - informal exchange. High quality products from these sheds have attracted formal sector traders who regularly buy from these clusters and also sell them inputs.<sup>13</sup> They are licensed to operate by the municipal councils and are usually regulated by trade associations. The metal and carpentry trades are male dominated whereas the tailoring and knitwear clusters have a large number of women entrepreneurs in it.

The issue of quality and quantity gaps is common to most small producers and suppliers. But evidence suggests that high volume buyers nonetheless have tremendous goodwill towards jua kali entrepreneurs and small scale farmers and want to be able to place larger orders with them and to establish reliable business relationships. A recent study of such buyers in Nairobi showed that 87% of the survey sample ( this included schools , hospitals and large firms ) in Nairobi buy vegetables, fruit, furniture and stationary from small producers<sup>14</sup>.

The role of NGOs in Kenya in moving informal enterprises towards formal linkages through technical and financial support is significant in its demonstration effect but comparatively small given the numbers of MSEs in the country. An example from the work of the Kenya Gatsby Trust (KGT) shows how the mediation of a reliable “formal” partner such as a registered NGO with a good track record can offer a bridge between formal and informal in the domestic market and start the process of formalization as new linkages are tested and proven successful. KGT is helping MSEs to supply about 300,000 hurricane lantern handles to Cook 'n Lite, a large formal sector company eager to build the capacity of local artisans, to outsource production (since it is cheaper) and to increase its exports. Five other companies are asking for similar arrangements and a Gatsby Subcontracting Club is being set up to develop clusters of MSEs supplying bigger firms with inputs or services.

Contract offers and invoicing are also sometimes done through the NGOs where large buyers have found the suppliers to be unreliable or not producing the quality required. The NGOs through donor subsidy and fees charged to the buyers and suppliers are able to offer the support required for particular orders. They also open markets for new products through R and D and identification of a market niche. This is happening currently with niche products such as organic produce, herbal teas, neem and aloe products.

In enterprises of the poor, formal and informal processes weave in and out of each other. Not every informal sector enterprise chooses to ignore all the laws that an enterprise must uphold, but also, not every formal sector enterprise abides by all the

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<sup>12</sup> “Jua kali” in Kiswahili means “hot sun” and refers to the informal artisans and traders working under the open sky and a very hot sun !

<sup>13</sup> Nabutola W., “Improving the Regulatory Framework for Income Enhancement of the Urban Poor : A Case Study of Nairobi”, unpublished paper, September 2006.

<sup>14</sup> Akumu W., “Who’s Buying Jua Kali?”, *The Sunday Nation*, 15<sup>th</sup> October, 2006.

**laws, rules and requirements concerning production and commercial activities. An observation from an analysis of data on informal enterprises in three countries and the “formalization” process is pertinent here:**

**The difficulty is one of knowing just what this (formalization) means. Is it essentially helping very small enterprises to grow? Is it the most important dimension of modernization (or of mechanization)? How important is registration, fiscalization and general legalization in that process? .....they are different processes; one can advance along one of these tracks without this implying a corresponding movement on the others....The terminology of informality and formalization makes it easy to ignore these differences, implying that all these are closely linked to corresponding movement on each of the others. The data make it clear that the world is not like that.<sup>15</sup>**

**Text Box A profiles the textile clothing subsector and shows how formal and informal activities are inextricably linked. It also underlines the need for improved physical facilities and enhanced skills.**

#### **Box A. MSEs in the Textile Garment Sector**

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<sup>15</sup> Mead D. and Morrisson C., “The Informal Sector Elephant”, *World Development*, Vol.24, No.10, 1996.

The current situation in the textile and garments industry provides useful insights on linkages existing between formal and informal businesses. Alongside the formal clothing industry, clusters of informal sector tailors are engaged in making clothes and interior furnishings for both low income consumers in the immediate neighbourhoods and for supplying to shops, hotels, restaurants and schools. In fact, there are over 60,000 manufacturing MSEs which produce clothes for the domestic market. About a third of the owners are women and majority of these firms are located in rural areas and small towns. Almost all started with own savings or loans from family and friends but have expanded with formal credit now more readily available than previously through MFIs. Supplier credit is also used in some firms. All inputs are purchased through traders whose source is the formal sector. The next tier which employs from 50 to 150 people also supplies the higher income end of the domestic market and exports regionally. They include mills that spin fibres into yarn and factories for cardigans, knitwear and clothing. The third tier has large export-oriented firms sub-contracted by multinational firms. These very large firms which numbered only 15 at the start of the concession period doubled in number to 30 in response to AGOA (the African Growth and Opportunity Act of the USA) and have declined in number to about 20 at present.

The main business linkages of garment related MSEs are with other MSEs and individuals who are connected to distribution channels which include wholesalers. Some producers also have trading links across borders and use a network of friends and relatives to find markets beyond the local ones. Their main competition is from “mitumba” (imported second hand clothing) whose prices are only 10 to 30 per cent of comparable new garments. The MSEs are often located in crowded stalls with limited access to electricity and in conditions which are hazardous. They work long hours on machines sourced from formal businesses or cast off by manufacturing plants offloading excess capacity. In terms of skills, there is sometimes a degree of specialization especially among those who own special machines for cutting. Some tailors are retrenched workers from the formal clothing industry (which has suffered a major slump over the last decade) and so they have brought their skills to the informal sector. There is very limited access to information about inputs, prices or markets. As in other MSEs, word of mouth is the most used source. Limited in their knowledge and skills, garment producers, as in the case of other small scale manufacturing, essentially copy and replicate what they see selling rather than innovate and design.

Regulatory changes alone are not enough in upgrading both the informal and formal enterprises in the textile sector but they can provide the impetus to more resources getting mobilized to address the multifaceted constraints. For example, sector specific human resource development and productivity enhancement needs attention if Kenya is to be a global player. As in other sectors, there is no serious human resource development strategy for this industry and this together with power shortages, lack of access to finance, lack of sustained updating of knowledge all contribute to making both the formal and informal parts of the textile and clothing industry uncompetitive both regionally and internationally.

*Source : McCormick D et al, 'Textiles and Clothing :Global Players and Local Struggles', in McCormick D. et al, in Business in Kenya, University of Nairobi Press, forthcoming.*

## ***2.4 What supports and what constrains growth: Some examples***

**This section draws on recent Kenyan research to suggest what is helping the informal sector entrepreneurs to grow towards greater profits and formalization. Financial and non-financial support services are further elaborated upon in Sections 4 and 5 of this paper.**

**Businesses grow through increased use of both financial and non-financial services, greater market reach, better prices, and business linkages. All of these require some degree of “formalization” so that there be some modicum of predictability and reliability in terms of premises, ability to deliver on orders according to formally set quality standards, etc.. Growth and diversification therefore require**

- readily available financial services
- access to infrastructure
- some degree of security of tenure
- access to business and technical skills
- affordable tools, raw materials and inputs
- a considerably improved knowledge of business processes and options
- some degree of regulatory compliance

**But above all, they require the motivation to be enterprising as observed in studies of growth-oriented informal entrepreneurs.**

### ***The “Can-do” Attitude***

**Kenneth King in his comment on microenterprises “against the background of the formal globalizing economy” has an interesting insight on differentiation within the very large jua kali sub sector in Kenya.<sup>16</sup> He suggests that the contrast is not between urban or rural informal sectors, “but between what may loosely be termed subsistence and entrepreneurial forms of self-employment”. He also confirms the fallacy as pointed out by Mead and Morrison of assuming that “formalization” of any one informal characteristic (for example, secure tenure or fixed premises) necessarily means there is corresponding positive movement along another characteristic, and continues: “This broad distinction does not point to a simple contrast between those working in permanent premises with access to electricity and those in less secure settings.” He illustrates three levels of “permanency” as regards secure tenure and concludes that these “distinctions of permanency and security have no direct correlations with subsistence versus entrepreneurial forms of self-employment”.**

**Instead he recognizes the importance of the “can-do” mentality acquired over time by those who have left the formal sector and entered the informal and also of those**

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<sup>16</sup> King K. “Microenterprise: Macroeconomic Environment: Revisiting Kenya’s Informal (Jua Kali) Sector Against the Background of the Formal Globalizing Economy”, *International Journal of Educational Development*, Vol. 16, No.4, 1996.

who have developed it entirely within the informal sector. He also recognizes the relevance of the skills acquired working in formal small and medium-sized enterprises and brought to informal enterprises. Those who have had varied work and training experience including employment before venturing into self-employment are able to move their enterprises towards growth more successfully.

Research recently undertaken by Mary Njeri Kinyanjui on growth-oriented (defined by her as employing an increased number of employees over time) rural MSEs (covering a wide range from retail trading to small-scale manufacturing of animal feeds and metalwork) in Kenya's Central Province supports King's thesis about the momentum set by the entrepreneurial spirit. She found that growth-oriented businesses "are not founded by chance but are established to fulfill entrepreneurs' desires and to a lesser extent (are driven by) social and market factors".<sup>17</sup> Her findings also suggest the importance of the "can do" attitude in charting the course to growth. Kinyanjui saw this reflected in "unique strategies for running businesses such as ability to communicate, patience, working long hours, use of market principles for pricing, giving credit, and advertising".

### *Funds and Markets*

Although Kinyanjui's study area, Kenya's Central Province, is reasonably well endowed in terms of formal finance outlets in the form of MFIs and banks, most of Kinyanjui's respondents felt that it was difficult to obtain loans as they had to show credit records and they did not fully understand the requirements for getting and repaying loans. Most drew start-up funds from family, friends, savings and credit cooperatives (SACCOs) and personal savings, but once established took loans, in order to finance and sustain the growth of businesses.

Although several of the sampled businesses took loans from MFIs, they pointed to several issues of concern:<sup>18</sup>

- Loans are based on MFIs' assessment of repayment records. This means applications are considered on the basis of previous status with an MFI rather than actual current business performance.
- The demand by most MFIs for weekly payment is too stringent.
- Group-based lending and borrowing takes up too much of the businessperson's time in terms of group meetings.
- Group guarantees have no legal recourse against defaulters.
- Small producers sometimes have to wait several months before harvesting and getting cash for loan repayment, but they are still expected to repay each week.
- Repayment cycles do not reflect business cycles, especially in agricultural areas.

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<sup>17</sup> Kinyanjui M.N., "Overcoming Barriers to Enterprise Growth: The Experience of MSEs in Rural Central Kenya", unpublished report presented to Technoserve, Nairobi, July 2006.

<sup>18</sup> Kinyanjui M.N., *ibid.*

**In their analysis of sources of growth for garment enterprises, of which the majority are MSEs, McCormick, Kinyanjui and Ongile found that two factors were critical: demand for new clothing and a firm's initial capital.<sup>19</sup> Approximately 26% of the entrepreneurs put "low demand" as the most serious problem faced by their businesses. The second most serious problem cited was financial system gaps. Current employment size of any firm was seen as related in a linear way to initial capital outlay. As in Kinyanjui's Central Kenya sample, initial capital in the garment enterprises was drawn from savings, or loans and gifts from family and friends. Even where entrepreneurs owned land which could serve as collateral for formal credit, they were reluctant to use it, fearful of losing it should the business fail. This reluctance is in fact echoed in the lending experience of small banks and MFIs. Credit to buy supplies remains a constant challenge.**

**The 1999 Baseline Survey on Kenyan MSEs also found that MSEs considered access to markets as their biggest constraint followed by the need for increased credit.**

#### *Education and Risk Tolerance*

**Kinyanjui's sample confirmed a widely held belief based on the work in the 1990s of the USAID GEMINI studies on African microenterprises that about one-third of MSEs are growth-oriented. Her field survey confirmed King's findings that "previous occupation" was the main source of business knowledge and that levels of education were also correlated with business success. Relationship between age, education and business growth were found to be significant, with entrepreneurs in their mid-thirties performing particularly well.**

**A majority of those who had taken business risks (such as loans, product diversification, giving credit, expensive machines) also reported growth. There was also a correlation between levels of education and risk taking – a high percentage of risk takers had more years of schooling than others. No significant gender differences were found with regard to factors contributing to growth and success.**

#### *Appropriate location*

**In recent removal of hawkers from Nairobi's central business district, the main outcry has been the loss of locations close to the customer base. In a recent survey, the Nairobi Central Business District (NCBD) Association asked street traders about their earnings. The responses show that approximately 10,000 traders collectively own a daily capital stock of almost a million dollars.<sup>20</sup> Their average per capita profit is 72 dollars per month, ten dollars more than the national minimum**

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<sup>19</sup> McCormick D. et al., 'Growth and Barriers to Growth Among Nairobi's Small and Medium-Sized Garment Producers', *World Development*, Vol. 25, No. 7, 1997.

<sup>20</sup> This and the income statistic in the sentence which follows are quoted in Nabutola W. ( chairman of the NCBD), "Improving the Regulatory Framework for Income Enhancement of the Urban Poor", Nairobi, 2006.

wage. The survey interviewed the same respondents after their relocation out of the NCBD and found a clear decline in incomes. While the relocation reduces congestion in the central part of the city, it does affect the profits and indeed the mortality of the trading microenterprises.

*SMEs (small and medium enterprises) filling the missing middle*

SMEs can provide the stepping stone for the growth oriented micro enterprises into the opportunities of the formal economy. At present, this is not the case. According to the SME Solution Center or SSC in Nairobi, some Kenyan SMEs can show an asset base and an annual turnover of a few million shillings. The SSC's experience shows SMEs are investing in the tourism sector, manufacturing and agro processing. Most SSC clients have had some previous experience in business, can offer credible track records and attract bank loans. These are the kind of SMEs which can fill the missing middle. The domestic market has many unexploited opportunities which have not been taken up. Currently almost all value addition is concentrated in the largest urban areas; the private sector has not adequately recognized the potential of rural areas. The Kenyan mentality of relying on either the public sector (an attitude acquired during the pre-liberalization era) or donors to put up processing facilities needs to be replaced by entrepreneurial and commercially viable activity connecting the formal and informal. One such opportunity is profiled in Box B on milk chilling plants, a business hub for the smaller and larger players in the dairy subsector.

**Box B. The Informal Base of Kenya's Dairy Industry**

Eighty per cent of the milk production and sales in Kenya is informal. After the liberalization of the economy, the dairy cooperatives and Kenya Cooperative Creameries Ltd. (KCC), the cooperative-owned monopoly organization (parastatal) responsible for the processing and marketing of milk, disintegrated due to management inefficiencies, corruption and competition. In the face of the institutional vacuum, informal hawkers became the service providers for majority of the small scale farmers. Ideally, raw milk should be chilled within two hours of production to minimize bacterial multiplication. Since there is a shortage of chilling plants, most hawkers typically sell the milk in the vicinity of farms. In major urban centres, they draw on the peri-urban farmers. If the health implications of unpasteurised and informally preserved milk are taken seriously, then the informal milk sellers have to be encouraged to register/ be licensed; they could subsequently be persuaded through initiatives to develop their skills in hygienic handling of milk such that they can be assured of a continuing role in the dairy value chain.

The market's demand for raw milk "straight from the cow" is huge but it still does not use up all the milk produced. The surplus milk should be taken to collection centres where it can be chilled and then taken to the milk processors for pasteurising and packaging for sale but there is a huge vacuum in terms of the smaller producers' access to cooling facilities. Local entrepreneurs have still not picked up the bulking and chilling functions previously performed by cooperatives supplying the KCC. These are the key nodes in the cold chain for dairy. Some NGOs are addressing this gap through technical support to dairy cooperatives and establishing new chilling hubs. They subsidize the technical assistance necessary for the establishment and development of business hubs for the dairy value chain where small producers can purchase feed supplies, artificial insemination services and extension advice. Here they also access chilling plants which buy the unprocessed milk. The milk is then sold to the larger pasteurizing plants or the rural milk bars which package the milk into small sachets which are cheaper and smaller than the supermarket one or half litre tetrapaks. These links mean that a greater number of small producers are able to access larger markets.

### *Suitable secure premises*

**A significant factor constraining growth was found to be the lack of suitable secure premises. Suitable here means sufficient space, sanitation, adequate lighting, access to basic infrastructure and proximity or reasonable transport to input and output markets. Most MSEs have no security of tenure and live in fear of eviction by municipal councils who could at any time allocate their space to another use. Irregular land allocations have exacerbated the problem. A report on the misallocation of MSE workplaces is informative.<sup>21</sup>**

**Across the country, there is evidence of encroachment of land meant for Jua Kali developments....<sup>22</sup> parcels of land in various towns have been encroached by various interest groups. Public officials have been involved in subdivision of this land, later selling it to private developers ....The Ndung'u Report...indicates that about 585 cases of land approximating over 39 hectares belonging to the Kenya Industrial Estate which was reserved for ...provision of worksites through the incubator model, has over the years been irregularly allocated to private developers.**

**This kind of diversion of land intended for worksites for MSEs has been common across the country. This government has promised greater transparency but distrust between the jua kali and the public sector continues.**

### *Research and Development*

**All Kenyan businesses, large and small, suffer from lack of access to new knowledge, research and development (R and D) for product development and information on more efficient production processes and marketing.<sup>22</sup> R and D, like market information, is a public good which so far the public sector has failed to deliver. The R and D for the small-scale manufacturing units in the jua kali sector is sometimes done by NGOs and is more recently being facilitated through mentoring with a specific set of artisans. The new product is then absorbed and spread across the jua kali sector. The jua kali sector is marked by replication of products rather than innovation. What sells in one place gets copied in another since its marketability has been demonstrated. However, this risk-averse behaviour in fact leads to a lowering of prices and sales.**

## **3.0 Regulatory Reform: Improving the Business Environment**

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<sup>21</sup> Moyi E. and Njiraini P., *Misallocation of Workspaces for MSEs in Kenya: Some Lessons and Models*, Kenya Institute for Public Policy Research and Analysis, KIPPRA Discussion Paper No.53, Dec. 2005.

<sup>22</sup> Author's interviews with small and medium-sized formal sector food processing firms.

Creating an environment for more growth, risk taking, market intelligence, linkages between businesses and trust in the legal and regulatory institutions is the role of government. The following section describes relevant reforms underway or undertaken in recent years.

### *3.1 Doing Business*

The World Bank's recently released report *Doing Business 2007* places Kenya 83<sup>rd</sup> out of 175 countries, ten levels above China (93<sup>rd</sup> place)! This recognizes the tremendous energy that Kenyan businesses have unleashed over the last four years, but still leaves Kenya behind the frontrunners in sub-Saharan Africa: South Africa, Mauritius, Namibia and Botswana. *Doing Business* ratings measure 10 major dimensions with regard to the ease of doing business;<sup>23</sup> starting a business; dealing with licences; employing workers; registering property; getting credit; protecting investors; paying taxes; trading across borders; enforcing contracts; and closing a business. Starting a business in Kenya requires that 11 procedures be followed. This can take on average 170 days. This applies of course to the formal sector businesses. Closing businesses can take several years ! Import and export procedures are among the most cumbersome in the world (Kenya is at 145<sup>th</sup> place out of 175). The growth of small businesses and their ability to link to larger businesses is adversely affected by regulatory barriers at virtually every stage of business establishment and operations.

### *3.2 Licensing Reform, Proposed Policies and Business Sector Support*

Many Kenyan MSEs are covered by some kind of formal registration whether this be as self help groups, societies or as individual enterprises. The cost of such registration is nominal but entrepreneurs find the procedures to be followed and information about offices to be visited for requisite forms and registration to be confusing. There are no "one-stop shops" which inform an aspiring entrepreneur what is required of him or her in terms of regulations to be followed for licensing. Word of mouth is used for information dissemination and most MSEs do manage to acquire some form of licensing and registration recognized by local, provincial and central government. In the rural areas, farmers increasingly come together as self-help groups to get better deals with their buyers. These groups functioning as business entities are able to bulk their produce and purchase services so that they can meet the specifications of their buyers. They register with the Ministry of Social Services through the District Social Development Office. Local authorities can license individual and "informal" microenterprises.

Kenya has had a series of policy papers drawn up to support the legal recognition and support to MSEs. The need for deregulation in order to reduce the cost of doing business was recognized in the 1992 Sessional Paper on Micro and Small Enterprises. Para 2.1 stated "A tightly regulated economy works to the disadvantage of small business". Changes implemented since 1992 include

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<sup>23</sup> Bindra S., "Doing Business in Kenya Still Too Hard", *The Sunday Nation*, Nairobi, October 15, 2006.

**amendment of the Trade Licensing Act (Cap 497) to discontinue the collection of trade licensing fees, repeal of the Vagrancy Act (Cap 58), which prohibits hawking, and the amendment of the Chief's Authority Act (Cap 128) and the Public Order Act (Cap 57).**

**In the 1998/1999 budget speech, the Government of the time announced that local authorities would henceforth issue only one Single Business Permit (SBP) to eight categories of businesses within their jurisdiction. Many of the informal sector activities such as vending and small scale services were covered under these. The local authorities were mandated to do this licensing. In actual fact, since local authorities have considerable influence on business costs through the enforcement of a large number of bylaws, the SBP alone has not been able to eliminate the harassment of the small businessperson.**

**After the SBP, the momentum for regulatory reform picked up after a factfinding mission of the Foreign Investment Advisory Service (FIAS) of the International Finance Corporation and the World Bank. The mission drew up a detailed report on the status of regulatory barriers to investment and commerce and made all encompassing recommendations. <sup>24</sup>A Working Committee was set up by the Government to guide the Ministries of Trade and Industry and of Finance on licensing reform. The Committee worked with 178 public bodies and private sector associations to identify 1,347 licences required by various types of business, large and small<sup>25</sup> which were costly to business. In 2005, the Government's decision to cut down the multiplicity and duplication of licensing was presented in the Statute Law (Miscellaneous Amendments) Bill: <sup>26</sup>**

**The purpose of this Bill is to refine the legal framework of the licensing regime governing the conduct of business activity in Kenya. In this respect, the Bill seeks to abolish several licences that impact negatively on the cost of doing business in Kenya. These licences are either outdated or impose higher costs to users as compared to the anticipated benefits.**

**Nine licences were abolished in 2005 and another 28 in June, 2006. In September 2006, the Minister of Trade and Industry also announced that the trade licence was being abolished as it was a hangover from the colonial days in order to exclude trade in commodities set aside for export by the settlers. Many of the regulatory barriers have emerged from the colonial period and were in fact put in place to curb entrepreneurial initiative; Kenya has still not taken apart what is relevant fifty to seventy years since these rules and regulations were first put in place.**

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<sup>24</sup> FIAS, "Kenya: Accelerating Reforms to Improve The Commercial Legal Framework and Remove Administrative and Regulatory Barriers to Investment", June 2004.

<sup>25</sup> Masau B., "Executive Summary Report of the Working Committee on Regulatory Reforms for Business Activity in Kenya, 2005.

<sup>26</sup> Republic of Kenya, *Kenya Gazette Supplement Bills 2005*, Government Printer, June 2005.

**Local government by-laws are the most immediate and daily source of harassment of informal sector entrepreneurs. Bylaws applied by many local authorities are not standardized and inhibit rather than facilitate business activity. At the same time, the Provincial Administration tends to overlap and conflict with local authorities over the enforcement of regulations, as well as on jurisdiction over land and utilities. The overlap and conflicting implementation allow considerable scope for small bribes as a way of surviving and sustaining a customer base in a certain area. Local government reform has been underway for several years now but is not as yet complete. Unless some sections (Section 163 of the local Government Act, for example, gives sweeping powers to Local authorities to ‘prohibit and control’ large sections of the MSE sector<sup>27</sup>) of Local Government Act Cap 265 are amended, the more unscrupulous officials in local authorities could continue to misuse their authority over the SBP and the enforcement of bylaws.**

**Nonetheless, positive changes can be noticed in urban areas: land has been set aside for terminals for small scale transport (called matatus) operators and street vendors. There has also been some land regularization at the city level with the Nairobi City Council amenable to offering land titles to community trusts in some of the informal settlements on government/public land. Within these settlements, civil society organizations are negotiating for space to be set aside for enterprise development. This does not however balance the illegal allocation of land which has been rife in Kenya and which means that land scarcity remains a major constraint to small scale entrepreneurship.**

**The policy framework for MSEs was laid out in Sessional Paper No. 2 of 2005 on Development of Micro and Small Enterprises for Wealth Creation for Poverty Reduction. In it, the government recognizes MSEs as dynamic private sector players and not a residual sector. There is provision in the Paper for 25% of public procurement being allocated to MSEs. The Paper also proposes the establishment of a National Council for Small Enterprises to advise on the sector and to fundraise for its capacity development. This policy document however has yet to be enacted as an Act of Parliament. Meanwhile the implementation framework for the proposals contained in the Sessional Paper is being drafted under the lead of the Kenya Private Sector Alliance, an umbrella body for the private sector. Since the Sessional Paper recommends further development of small entrepreneurs’ associations to assist each other and to provide a viable institutional structure for self-regulation of the MSE sector, the national Jua Kali Association and the city hawkers’ associations will be encouraged to create among its membership business clusters to be supported through land allotment by the local authorities and technical support through other government agencies. The Ministry of Labour is charged with the bringing of the Bill to Parliament but through donor initiatives underway, it is the Ministry of Trade and Industry which is charged with designing support to the growth oriented MSEs. There is therefore some lack of clarity as to who the official champion of MSEs is.**

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<sup>27</sup> Ronge E., “Regulatory Reform Policies and the Enabling Environment for MSEs”, KIPPRA, Nairobi, 2004.

Another piece of pending legislation is the Microfinance Bill which has been vetted over the last three years and now awaits passage through Parliament. There are still issues of regulation and minimum deposits which are being vigorously debated in the microfinance industry and which must reach agreement before enactment. In order to become deposit taking institutions, MFIs must be supervised or regulated and that is the main rationale for the Microfinance Bill which is currently before Parliament. The main objective of the Bill is to provide a legal framework for the regulation of the MFIs and to ensure that they are financially stable. There are protests about the regulation to be done by the Central Bank of Kenya (CBK). Media comments state that since CBK does not have the resources to even adequately supervise the formal banking sector, broadening its mandate to include MFIs will result in inefficiencies. The impact of these inefficiencies will ultimately be passed on to the small entrepreneurs. An important question to ask and answer is how many MFIs can the CBK supervise effectively. Another is whether the proposed MFI licensing requirement for a minimum capital of 60 million Kenya shillings (20 million shillings for those operating only in rural areas) is reasonable. On the other hand, there is recognition across the MFIs that their enhanced formal status would allow increased access to borrowed funds and credit lines and therefore could mean a larger scale of operations. The regular monitoring will also have cost implications for accounting and reporting and additional personnel and expenses have also to be considered.

Through the Ministry of Trade and Industry, the Government is set to launch a Private Sector Development Strategy (PSDS) in the near future. The PSDS implementation is heavily reliant on Danish support to the Government of Kenya under its five year Business Sector Program Support which was announced in September 2006. The objectives of both the PSDS and BSPS are very similar. The BSPS components are targeted towards :

- an improved business environment.
- enhanced competitiveness of medium, small and micro enterprises.
- an improved labour market.

The present limitations on the growth of MSEs will be addressed through increased business linkages within a value chain framework of interventions. An active role on the part of the manufacturing sector and government in sub-contracting MSEs will also be encouraged.

### *3.3. Implementation of Workplace and Environmental Regulations*

Workplace regulations in terms of minimum wage regulations are rarely enforced in MSEs and health and safety surveillance is limited to visits by the relevant officers sometimes only once a year. Their role tends to be advisory rather than that of strict enforcement. Most micro and small scale entrepreneurs are not even aware of the health and safety precautions that could be undertaken.

Environmental Regulations are laid down in the Environmental Management Coordination Act (EMCA) of 1999 implemented by the National Environment Management Agency (NEMA). For environmental education and active engagement of MSEs in environmental monitoring, NEMA's work requires reinforcement at local levels through other agencies as well. Small scale industries and business can have significant environmental and health impacts. Examples include charcoal making (a widespread activity in the drylands which produces amounts large enough to be exported) and small scale brickmaking both of which contribute to deforestation. The lack of sanitation and adequate water near most microenterprise locations means raw sewage is disposed of unsafely and stagnant water is used even in establishments selling food. Waste from the micro enterprises is often left at sites of business. Extraction of resources through activities such as sand and limestone mining often continue unabated.

EMCA requires that all enterprises in Kenya undertake annual environmental audits. A roster of environmental experts exists at NEMA but is neither accredited nor easy to access. Many businesses, large and small, ignore this regulation as NEMA is currently severely constrained in its capacity to enforce it. Some gradation in the kind of environmental guidance and regulation appropriate for different kinds of enterprises and the cost of it to the enterprise has to be worked out. While looking for guidance on how implementation of environmental guidelines is possible at the level of MSEs, NEMA has recently started clamping down on environmentally unsound activities such as salt mining in lagoons which harbour mangroves, coral etc..

#### **4.0 Broadening and Deepening the Reach of Financial Services**

This section describes the present status of financial services available to MSEs and the poorer households.

##### **4.1 Moneylenders, Family, the Larger MFIs and "Small Loans" Banks**

The 1999 Baseline Survey on MSEs showed that only about 10% of the MSEs accessed formal sources of credit. There was also use of informal moneylenders (whose interest rates can be almost double that of the MFIs) and of loans from friends and family especially for starting up businesses. MFIs tend to work with groups which show market potential or individual businesses or clients who have a track record of successful repayment. This means that getting start up loans is a problem for business aspirants.

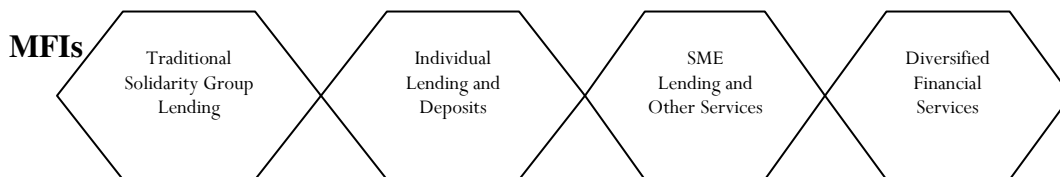
Over the last decade, MFIs have continued to expand all over the country. A survey being conducted at present by Financial Sector Deepening Trust supported by Dfid and the World Bank and due to report at the end of November 2006, will calculate more precisely what the outreach of the various financial institutions is. Present estimates suggest that the three "small loans" banks (this does not mean that there is

a ceiling on the size of their loans but that they offer much smaller loans than any other banks would consider giving) - The Equity Bank, K-Rep Bank and the Cooperative Bank - together reach about 1,300,000 clients<sup>28</sup>. The larger MFIs are altogether serving about 300,000 clients with the biggest one reaching about 70,000 people. Not all of these loans are for businesses and not all business loans are used for developing enterprises. Nonetheless the outreach has established that households, self-help groups and enterprises all over Kenya have funds to offer as savings and can and want to use credit.

A major factor inhibiting both banks and MFIs from increasing their lending to small business is the absence of credit referencing systems in the country. A common register to provide financiers with the credit history of any enterprise big or small would be an important contribution to the opening up of financial services to MSEs. Most banks deal with businesses which can show a track record of success and an ability to service loans. At least three of the formal banks, Standard Chartered, Stanbic, and the Commercial Bank of Africa have starting lending for small business or offering wholesale credit to the MFIs. The larger formal banks tend to have 700,000 to 1 million shillings as a minimum loan. The loan is only negotiated after client assessment through review of financial statements of at least three years and the bank’s own evaluation and company registry search of the applicant. Traceability is important so fixed premises and an address are expected. This kind of pre-loan scrutiny is obviously better suited to the small to medium sized firms rather than those at the base of the MSEs. The loan conditions are attractive. In early October 2006, Stanbic Bank for example offered a repayment period on Small Business loans of up to 15 years at an interest rate of 15.5% which is lower than the rate being charged on other kinds of bank loans. Another bank has lent several million shillings to an MFI against a guarantee from donors.

For MSEs there are several sources of credit: banks, MFIs, SACCOs, ROSCAs/ASCAs/Village Banks and friends and family or informal lenders. There are three banks which cater specifically to small loans including those to MSEs : the K-Rep Bank, the Equity Bank and the Cooperative Bank. Of these the Cooperative Bank is the oldest as it began in the era of cooperatives as the main producer groups in Kenya (1960s and 1970s) and its clientele ranges from SACCO (Savings and Credit Cooperatives) members to large cooperatives.

**Fig 1. Financial Services Continuum<sup>29</sup>**



<sup>28</sup> Statistics based on the 3 banks’ reports to the Central Bank of Kenya, June 2006.

<sup>29</sup> Christensen P.D., “Upscaling –Investing in the Growth of Microfinance Institutions”, a presentation to the Gatsby Inter-Trust Seminar, Zanzibar, May , 2006.

**K-Rep Bank graduated out of the microfinance component of the Kenya Rural Enterprise Program (K-REP) designed and supported by USAID initially in 1984 and then a number of other donors through the 1980s. In 1989, it expanded into direct service provision and in 1998, was transformed into a private commercial bank in order to capture savings and offer financial services beyond just micro lending. K-Rep uses both the group based approach and individual lending. About 50% of the total portfolio is for the groups and the rest is retail or individual lending. The collateral in the group approach is “social collateral”- group guarantee. The fact that social collateral does work has been amply demonstrated by the experience of K-Rep over many years of being an MFI and a Bank. Repayment rates on loans guaranteed by social collateral have consistently been very high with an extremely low ( 2% or less) default rate.**

**After K-REP was able to show the success of this approach, the Central Bank of Kenya was agreeable to the use of this instead of the requirement for the more tangible or physical assets. For those able to offer the physical collateral, this might be combined with cash receivables. Given the somewhat “confused” status of land registration in Kenya, if land title deeds are used as collateral, they are usually complemented by other forms of collateral as well.**

### **Box C. Green Assets!**

Approached by a Business Services Facilitator working with avocado farmers, Equity Bank customized its loan procedures and product to suit the requirements of several thousand avocado farmers trying to upgrade their production through the use of expensive spray equipment and pesticide. The facilitator was able to negotiate with Equity Bank on behalf of the farmers to extend credit to farmer groups for agrochemical services. The credit was backed by the supply contract with a reputable exporter of avocados. The Bank then proceeded to develop an appropriate loan product to meet the needs of the farmers and waived the usual collateral requirements. The exporter paid the farmers through the Bank which deducted the scheduled payments before releasing net proceeds to farmers. Farmers also signed chattels mortgage documents in which the definition of chattels was “stretched” to include avocado trees and their fruit !

*Source : Mwangi B, “ Using Value Chain Financing to Make Money Grow on Trees,” a presentation at the National Business Development Services Conference, 2006.*

**The Equity Bank is a recent development out of the Equity Building Society established in 1984. Equity Bank is growing steadily into the leading bank catering to small scale rural enterprises and agriculture with mobile (on wheels) banking units accessing even relatively remote rural locations. It has a large number of clients, about 800,000. Its origins lie in encouragement of very small farmers to pool their savings and open accounts. This is the base upon which it is still developing its market and engaging in the kind of flexible and innovative arrangements profiled in Box C.**

All three banks and MFIs use group guarantee mechanisms or some form of character referencing as well chattel mortgaging but these are essentially non-secured loans. None of them lend for startups but rather the enterprises which are already set up and show some degree of sturdiness.

The process of group formation on which to base the group guarantees is labour intensive and quite long. Credit officers spend eight weeks or more in communities working on formation of cohesive groups whose members can guarantee each other's loans. They study the patterns of trust and collective action which already exist and build on these. They dialogue with communities on credit and other financial services offered by MFIs and explain how group guarantees work. Repayment rates using the group method have been found to be acceptable.

#### *4.2 ROSCAs, ASCAs, FSAs and SACCOs*

The smallest loans and the largest number of savings and credit institutions are at the community level. They are the ROSCAs (Rotating and Savings Credit Associations), ASCAs (Accumulated Saving and Credit Associations) and the FSAs (Financial Services Associations) which are also called Village Banks. All of these are registered as associations with the Ministry of Culture and Social Services through the District Social Development Officers. The registration is not complicated and requires only a nominal fee. ROSCAs and ASCAs are community based and often informal groups for lending and saving which probably reach more people than all the others. They informally pool together savings and in turn lend to their members. The most common use of such money is for welfare purposes: household emergencies, weddings, funerals, medical expenses etc..

FSAs are also owned by the villagers and can lend on average 10,000 Kenya shillings per loanee. There are 70 FSAs in the country at present and the demand is growing. Their biggest challenge which in fact is the challenge facing most MFIs is that of good governance and management. FSAs are monitored by the K-Rep Development Agency

(KDA). KDA was set up to develop products and lending processes for the hard-to-reach groups in Kenya. For the oversight of FSAs, KDA charges them a management fee which the FSAs have been happy to pay. This demonstrates their ability to purchase business services commercially even at the village level. KDA is now developing professional auditing professionals at the district level who will in due course establish standards and training packages so that a degree of commercially available professional oversight of these associations and other MFIs becomes the norm at local levels.

A rung above the associations are the SACCOs which are registered with the Cooperative Bank of Kenya. To bring them under closer supervision, SACCOs will also now be allowed to open front offices and to operate as MFIs and a SACCO Bill has been drafted to fully implement this change of status. Meanwhile, SACCO bylaws have been reviewed and changed to make them more competitive in the

financial market. New energy is going into innovations such as the use of teller machines and mobile (phone) banking. Some SACCOs are aiming at competing with banking products and how far they succeed will become apparent in the coming months. The majority however are still operating with very rudimentary management skills and unable to design relevant products

#### ***4.3 Revolving Funds and Factoring Facilities***

Another credit mechanism is that of revolving funds and other forms of credit offered through NGOs engaged in development work and linked to particular income generating activities and microenterprise development. An interesting innovation which is drawing attention from both larger high volume firms and exporters supplying high value markets and their small scale suppliers is the Factoring Facility a model brought into Kenya by the Kenya Gatsby Trust (KGT). Box D outlines how it works.

#### **Box D. Factoring Facility as Financial Intermediation for MSEs**

Credit has been and will continue to be a bottleneck in subcontracting arrangements between large and small firms or farmers. This is where the mediation of NGOs, government and donors can come in. The Kenya Gatsby Trust has set up an innovative financing mechanism in the form of a Factoring Facility (FF) for linking small scale suppliers and large firms. This factoring facility currently works with a number of large firms including Kenya's most lucrative chain of supermarkets, the Nakumatt Supermarkets. Most small scale suppliers, farmers and artisans, cannot wait for payments from these companies which are their customers to finance their ongoing production. So to ensure that they meet their orders, they want cash up front. KGT offers this cash, based on the suppliers' invoices to their customers, the large firms. The firms pay KGT as the factoring facility what they owe their suppliers plus a fee. This then replenishes KGT's FF deposit from which it pays the farmers. Since there is a time lag between when the firms pay the FF and when the farmers want the cash, FF needs to have spare funds which at present is drawn from a donor grant but in future will be sourced as loans from commercial banks. Negotiations for this are in progress.

*Source: Timothy Nzioka and Beatrice Obara, staff at the Kenyan Gatsby Trust.*

#### ***4.4 Capacity Development of the MFIs***

For the larger MFIs which currently operate in Kenya, capacity development of the staff and the building of efficient organizational systems is subsidized largely through donor inputs. The cost of transition from MFIs to banks, which two of the larger MFIs have undergone, has also been met through donor funds. Donor subsidies for capacity development and for research and development are common across NGOs and MFIs. There has been some innovative work done on broadening the spectrum of financial products available such as savings options, insurance and microleasing. While microleasing products are being developed as part of donor programs in the agricultural and small scale business sectors, micro insurance is an emerging area that is not yet as well developed. K-Rep Bank has developed products

for insuring the premises, goods and lives of its MSE customers in association with an insurance company.

The financial sector in Kenya still meets only a fraction of the growing demand from the poorer households and MSEs.<sup>30</sup> For the expansion and strengthening of financial markets, interventions are necessary at a number of levels. The first is obviously at the policy level and the requirement of a regulatory framework within which markets can operate.

Meanwhile, MFIs continue to play the most critical role in the development of Kenya's financial market and increasing its reach. MFIs are constrained in their structure to only lending and unable to offer the range of financial services such as leasing or insurance which enterprises could use. They also fall short sometimes on the managerial and administration standards required to process a large number of short-term loans.

The microfinance institutions are also constrained by the conditions of operation and high transaction costs. Only a very small portion of their recurrent expenditure goes towards the development of new products etc.. There tends to be dependence on donor led initiatives to develop appropriate products; this is symptomatic of the state of pro-poor interventions in Kenya.

The largest players in the banking sector are only tentatively approaching MSEs through other financial intermediaries - two of the international banks are doing wholesale lending to MFIs. The option of large banks opening microfinance subsidiaries is not being taken up in Kenya. Reasons mainly have to do with the general lack of transparency at the level of MSEs since many are unregistered as businesses although licensed to engage in income generating activities.

The issue of the lack of collateral in the form of land or assets has not been described as a major impediment at the level of MFIs or banks. The state of land registers in Kenya can offer no guarantee at all that collateral in the form of land can be realized. In the 1990s during a period of economic decline in Kenya, there were a large number of non-performing loans in Kenya and banks had to write off many of them. Increasingly, alternative systems such as character referencing and receivables as collateral are being explored and adopted. Banks in Kenya are currently liquid and if guarantee schemes were to be offered by donors or the government, their outreach to small business would increase.

## **5.0 Developing a Business Development Services Market**

### **5.1 *NGOs have a demonstration role but who picks up the pilot ?***

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<sup>30</sup> Financial Services Deepening Kenya, *Briefing Note*, 2006.

**Business Development Services (BDS) are the whole range of commercial services which can support a business in**

- market access**
- business linkages**
- business infrastructure such as storage, computer services, transport etc.**
- input supply**
- training and technical assistance**
- access to technology**
- product development.**

**All these relate to improving a business's ability to improve its productivity and profitability. Most MSEs connect to other MSEs or NGOs to obtain most of the BDS. Large firms tend to connect to large firms and therein lies the dilemma over how to establish processes which raise MSE performance levels and improve standards to the extent that vertical business linkages become more common. MSEs expect support from the public sector in terms of extension advice but do not look to the larger firms in the private sector as a source of information and technical guidance. Some NGOs are facilitating connections to the larger firms and through this supplier contracts and embedded services are being initiated but this is still an emerging phenomenon.**

**The poor engaging in informal income generating activity are often not even aware of where they are located in terms of the wider market or what their own business potential is. There is therefore very little demand for BDS at that level. Technical advice and information on inputs and linkages is usually offered through NGOs who might choose to work with them but their coverage is small. The vast majority in the informal sector learn through peer exchange and observation of what is available and being used.**

**The first challenge then is to create the awareness of the value added by BDS and to create a demand for it. Three donor supported projects are currently supporting the development of demand based and business-like (i.e. delivered by other businesses) support services such as skills training, credit, input supplies, market information and business linkages in subsectors with growth potential: fish, horticulture, dairy, coffee, pyrethrum and cotton. Location specific associations or producers groups as well as apex associations are being formed. Production, storage and marketing interventions are being designed and delivered to reduce losses, lower the costs of production and increase sales. Small scale producers of technologies are being linked to "hard-to-reach" businesses and private sector based extension advice being packaged for use at the MSE level.**

**MSEs are usually risk averse as the risk in trying new technology or services produces uncertainty of outcomes and therefore the importance of demonstration cannot be ignored. The demonstration of institutional innovation, win-win business connections, and market development is often left to NGOs who facilitate this**

through donor grants and in partnership with the private sector. The private sector appreciates the mobilization, capacity and organizational development that NGOs are able to undertake at the level of the small scale suppliers for the value adding and manufacturing industries. There are many examples in Kenya of intermediation and innovation through NGO- private sector partnerships but these touch only a few of the millions of MSEs in Kenya. How commercial BDS can be developed and delivered to the businesses of the poor is still an unanswered question.

Over the years, there has been a breakdown of trust between different levels of private sector activity because of the mismanagement of money and breach of contracts. This is changing in a few sectors with NGO/MFI mediation creating basic financial knowledge/discipline at the grassroots and new ways of organizing the poor and bulking supplies for sale to larger enterprises. An important question for scaling up from the pilots is whether private or public players are willing to facilitate similar linkages and offer services on a fully commercial basis. The challenge is to have MSEs themselves become adept at delivering services to other MSEs since they understand best their shortcomings and constraints. These service providers however need their own capacity enhanced and this is where public, private and civil society organizations have to play a role.

### *5.2 Embedded Services and Brokering*

In order to increase production of the supplies required for processing/exporting or in the retail sector for marketing, there are examples of embedded services being offered by processors/exporters. The mode of intervention can take the form of extension services, quality control over product standards and collection facilities. These address the supply issues around bulking/quantity and consistency of quality. Embedded services are being provided to their suppliers by some of the exporters and processors in the horticulture industry. But for the most part, small scale farmers and small scale manufacturers rely for advice and business linkages on brokers or middlemen/women. The middleman/woman or the broker/trader plays the crucial intermediary role of linking the small producer with every market other than the most local i.e. the village or small town market. It is the broker who often connects the producer with the input supplier, pulls together enough produce for the retailer, wholesaler, processor and/or exporter and informs (or misinforms) the producer about prices and product demand. Because the producer has no other source of market intelligence other than the broker, he or she is liable to exploitation.

## **6.0 Using Social Capital to Reach the Marginalized**

Women, pastoralist, youth and slum dwellers all suffer added disadvantages in urban and rural markets because of their particular constraints. They are able to

combat their disadvantage to some extent by coming together in groups formed around a common purpose, the basis of social capital.

### 6.1 *What is social capital ?*

Groups and networks are the base upon which much of the support being offered to marginalized people is channelled. This base of groups and networks is referred to in this paper as “social capital” . An appropriate definition comes from a woman called Eva Cox who described social capital in the context of other forms of capital .<sup>31</sup>

There are four major capital measures, one of which takes up far too much policy time and space at present. This is *financial capital*. *Physical capital* makes it onto the agenda because of the environmental movement. So there are fierce debates on trees, water, coal and what constitutes sustainable development. Some types of physical capital and financial capital deplete with overuse, or become scarce or too expensive. We occasionally mention *human capital* - the total of our skills and knowledge but rarely count its loss in unemployment.

There has been too little attention paid to *social capital*... Social capital refers to the processes between people which establish networks, norms, social trust and facilitate co-ordination and co-operation for mutual benefit....We increase social capital by working together voluntarily in egalitarian organisations. Learning some of the rough and tumble of group processes also has the advantages of connecting us with others.

Social capital in the form of producer groups, women’s groups, credit and savings groups or associations and cooperatives are a recurrent leitmotif in relationships between MSEs and MFIs, NGOs, supply chain partners and government. Well-managed and cohesive groups provide economies of scale, are important for capacity development, the nurturing of trust which is so vital in business relationships and as social collateral for use in accessing finances.

In most of the institutional and service innovations which have been taking place in terms of building the capacity of the MSEs, the formation of groups at the level of the small producers and the MSEs is a common theme. The farmers and entrepreneurs associations and groups are the social capital which is also the basis of the social collateral which is accepted by Kenyan MFIs and even some of the banks.

Developing and strengthening social capital is a labour intensive, long and a somewhat expensive process. It requires face to face dialogue, skills training,

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<sup>31</sup> Cox E. quoted in Bullen P. and Onyx J., *Measuring Social Capital in Five Cities in New South Wales*, March 1998.

**monitoring and outreach to areas not easily reached. Knowledge of local customs, languages, politics is needed in order to assess the context of those who want to engage in business. Most MSEs and small producers do not know where they are located in terms of markets for products and services. They have no or very limited understanding of where the various PSD resources are and how these can be reached. Their capacities to produce quality, negotiate contracts, manage financial transactions and implement activities needed to access inputs and markets vary greatly. All of these capacities need to be developed and continually supported – that means strengthening social capital is an ongoing process. The key question is who picks up the cost?**

## **6.2 Women**

**Women own only 1% of Kenya's land ( 5%-6% is held under joint names usually with the husband) although they till 80% of it. Eighty five per cent of their businesses are in the informal sector. <sup>32</sup>They are twice as likely as men to be operating homebased businesses and are on average earning about half of what men earn through MSEs. They are further removed than men from information about business processes and opportunities as their primary occupation is as caregivers. They engage mostly in trade and services and not in the higher paying manufacturing enterprises which are dominated by men.**

**To move into the higher value and more profitable small scale manufacturing sector, currently dominated by men, women need greater access to credit, technologies and to new skills. Most women continue on at the level of microenterprises without looking for ways to invest in new skills and technologies because the microenterprises help them meet daily household and family expenses. Moving in new directions is risky in a country without any social safety net provisions.**

**Women at a higher level of education and income security are however breaking into new areas such as tourist lodges and small hotels as well as transportation. Their entrepreneurship is also entering services such as education and small scale agroprocessing with promising results. They are well represented at all levels of the catering industry.**

**For the poorer women, women's groups are a way of breaking into new areas and accessing financial and non-financial services. Such groups are found all over the country; majority of Kenyan women belong to at least one such group, usually one for savings and credit. The Box below shows how group membership in one the poorest parts of Kenya and access to services changed her life. Women are pushing for greater equality in education, employment, business opportunities and access to services at all levels of Kenyan society. Networks and groups are forms of social capital.**

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<sup>32</sup> IFC and the World Bank, *Voices of Women Entrepreneurs in Kenya*, Washington DC.

### **6.3 Pastoralists**

**Pastoralists have yet to realize the market opportunity for livestock and meat sales. The bulk of contribution to the local and export meat supply comes from large scale commercial ranches, but huge untapped potential lies in the pastoralist areas which cover one third of Kenya. Pastoralists were set aside by the economic strategies of the colonial era which concentrated on cultivating its own settlers' capacity to raise commercial livestock for dairy and meat industries. The post-independence Kenya has not been able to revamp structures of exclusion and the economic potential of the arid and semi-arid lands ( ASAL) remains largely untapped. Another factor is that the traditional culture of pastoralist tribes values large herds of livestock as symbols of wealth and there has been resistance to regular sales or culling. Such an asset base however remains very vulnerable to drought and diseases and therefore under an ever present risk of devaluation. The challenge of building up a variety of assets and using market structures in these areas remains unmet. Drought earlier this year saw the livestock of pastoralists die after terrible emaciation. This has begun to demonstrate the importance of asset diversification.**

**Some NGOs have been working in ASAL areas helping form groups which can access credit and savings facilities. They are also promoting livelihood diversification in the face of drought. The result is a resilient resource of MSEs all over the small towns in ASAL which engage in handicrafts, trading and meat sales to the tourist lodges which dot the rugged and wildlife rich landscape. Women have been more active in retail kiosks where they employ help while they engage in livestock trading, an activity hitherto vetoed to women by custom. Socially it is more acceptable for women to own and trade in only small livestock i.e. poultry and goats. The ASAL women also engage in small scale vegetable farming. NGOs have been instrumental in improving the status of pastoralist women to the extent that they are now able to enter into trading and credit arrangements on their own.**

**The case study in Box E of a Samburu (a pastoralist tribe) woman assisted by an NGO illustrates how group support, credit facilitation and the “can do” attitude moved her to remarkable entrepreneurship.**

## **Box E. NATIKANYA SILAPIAN LEKOMET, A PASTORALIST WOMAN SPEAKS**

*Natikanya, a Samburu women's group member, describes how she learnt to do business and to succeed in it :*

My husband divorced me and married another wife and moved with to live with her in Maralal. He left me with nothing for our three children's upkeep. He even took the clothes that I had since he was the one who had bought them. In this state, I approached my uncle who gave me K. Shs. 200 to start brewing and selling chang'aa (a traditional brew). The money I got from chang'aa selling was just enough to feed me. I took my children to close relatives where they herded their livestock in exchange for food. I continued with the chang'aa business until SNV came along. I joined a women's group and through their microcredit scheme, I started selling tobacco and sugar in small quantities around our village. With that income, I bought a few goats which I bred until they grew large enough in number to be slaughtered. I sold the meat to the staff working in nearby tourist lodges. With this security of income, I took back my children and took two of them back to school while another older one started taking care of the herd that I had started building. Once my herd grew to a reasonable number, my former husband got to learn of it and came back trying to force his way back into the family. I refused his overtures. The following day my sister and I who is also a member of the same woman's group, reported this harassment to the chief who told my former husband that he had no business trying to force his way back into the family. I gave my ex-husband some food and a goat as he was leaving and told him that I could give him assistance in the form of food whenever he needed but nothing more. Currently my herd has grown and I now own over 90 goats and 30 of their kids. I also own a heifer, a camel and a donkey. My trading business is still continuing and I sell sugar, tea, maize flour and other commodities around the village. I have also learnt a lot about other business possibilities from the exchange visits which SNV organized for the women's groups and my knowledge about how to run a business and make it grow has also benefited from the many types of training we have received.

*Source: Author's interview with Natikanya Silapian in September 2005 (drawn here from a report submitted to the NGO SNV).*

### **6.4 Youth**

**Kenyan youth under the age of 30 comprise 75% of Kenya's population. Almost 70% of those unemployed are between the ages of 15 and 30 and the majority have no vocational or professional skills. It is not surprising then that a large number of unemployed youth are turning to crime as a way of life - over 50% of all convicted criminals are young men aged between 16 and 25 years.<sup>33</sup> The youth feel particularly disenfranchised as they have not been considered reliable or responsible in terms of managing finances by NGOs who have worked with them. They are therefore being encouraged now by the Ministry of Youth to organize themselves into groups under the auspices of credible NGOs. The NGOs can then approach the Government for grants under the YES-MSE Fund. The Youth Employment Scheme (YES) – MSE Program is the joint initiative of a number of donors and the Government for enhancing the entrepreneurial capacity of Kenyan youth so they can be better equipped for self employment. It will be a pilot for a few hundred youth and as with other projects outlined in this paper, a key question will**

<sup>33</sup> Statistics from the Ministry of Youth, Government of Kenya, 2006.

be – how will the lessons of such an initiative be taken to scale, empowering thousands of youth who will not have jobs and will have to be self employed ?

Social capital formation does not provide the full answer to the dilemma facing the educated unemployed or self employed youth. There are geologists, ICT experts, food technology graduates in the Kenyan marketplace who do not know where to begin to link to ongoing activities in their area of interest nor how to identify an opportunity and start a new business. The world of private sector human resource needs, the NGOs innovating with the poorer entrepreneurs and that of government and donors linking to create sectoral change is like a closed book to many youth. They are definitely the excluded in the world of enterprise development. Who seeks them out and informs them of options ?

The potential of youth playing the role of providers of services to MSEs is enormous. For example as micro and small entrepreneurs enter the marketplace and succeed , they might move further up towards formalisation. Company registration and responses to subsequent bureaucratic demands are time consuming and confusing. There exist virtually no support services to help navigation through this. Here is an avenue for the young and educated who can learn the requirements for formal business and for a fee facilitate them. Web-based application and registration processes, as has happened in parts of India , can also eliminate the face to face opportunity for corruption. This is again an area for future employment creation for the ICT - savvy younger generation. The telecommunications policy and the costs of operation so far discourage outsourcing and call centres in Kenya.

To respond to the youth and others disenfranchised, policy changes can create more economic opportunities and public-private mechanisms can implement initiatives to inform aspirants of business opportunities.

### **6.5 *Slum dwellers***

The livelihoods situation of urban slum dwellers is linked closely to their shelter situation. In urban informal settlements which are being regularized ( there are several instances of this in Kenya), there is housing development which allows for home based enterprises . Other schemes are designing space for community markets but in most of these slums, the usual way to earn a living remains petty trade or employment. There are rarely any outlets from the MFIs in these settlements but ROSCAs and NGOs abound. Urban agriculture is a growing phenomenon and the vegetables grown and milk and meat obtained are usually sold and consumed locally.

Slum populations are a vast market for MSEs but settlement economies are constrained by the absence of basic infrastructure and services restricting higher value enterprises

(like small scale manufacturing or tailoring beyond that which uses foot pedal machines). Lessons learnt from the experience of Kenyan CSOs in slum upgrading

and the development of shelter and services apply also to the situation of urban slum dwellers' livelihoods. These lessons from shelter related experience are noted here together with corresponding application to entrepreneurship in brackets<sup>34</sup> :

- Greater space for innovation at the community level is opening up as the political and policy environment becomes more responsive (Services and shelter construction are business opportunities for slum based entrepreneurs as low-cost options are formally approved).
- CSOs mobilizing community funds still rely quite heavily on donor grants (NGOs use donor grants to develop income generating opportunities in slums).
- Loans for incremental building are accommodated more easily by formal lenders when rental incomes are taken into account (incremental building which is now encouraged in slum upgrading schemes is related to entrepreneurship in that often a part of the new low-cost building is rented out/or used to run a small business to generate income which can contribute towards further building).

### **6.6 Who speaks for the poor?**

Most informal sector associations are ad hoc, coming together for a short time and for specific purposes. NGOs have had a role to play in setting up such associations and so unfortunately these last only as long as the project and the NGO support continue. Government and donors have also been strong proponents of sectoral associations. Associations that do thrive are born of felt need. These are formed for welfare and mutual insurance in order to assist members in times of social need, fundraising for weddings, burials and communal farming, etc..

Associations coming together to advocate for some degree of security of tenure and recognition in policy processes do not always stay the course of change processes or remain true to their original mandate. There are more than 400 jua kali associations with an apex body called the Jua Kali Federation.<sup>35</sup> The Federation is a frequent stakeholder in the many MSE conferences and workshops which take place in upmarket city hotels. Its performance in acquiring for its members business contracts or concessions on the technology upgrades their businesses so desperately need is unknown.

The voice of the poor and their business interests is not heard very loudly or clearly in the policy circles. Task forces and roundtables on the current sessional paper on MSEs invited stakeholder participation. But such participation did not extend longer than a few meetings. The long task force meetings tended to draw only the NGOs, the academics, donors and bureaucrats whose job descriptions include attending such meetings to work on MSE policy. The poor themselves have little time for this and their representatives who can now speak the language of the policy

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<sup>34</sup> Kapila S., "The Role of Civil Society in Mobilising Finance for Urban Low-income Shelter with Special Reference to Slum Upgrading : a Background Paper for UN-HABITAT's 2005 Global Report on Human Settlements, Nairobi, 2005.

<sup>35</sup> King K., *Jua Kali Kenya: Change and Development in an Informal Economy 1970-95*, James Curry, London; Ohio University Press, Athens, Ohio; and EAEP, Nairobi, 1996.

makers are not always in touch with their membership once elected to the executive of such associations. Political infiltration and interference are common to many of the umbrella bodies which are formed to represent the interests of the microenterprises and the small farmers who are in fact a large vote bank.

In sum, private sector organizations in Kenya are not strong or really connected to community level aspirations. They do not take up opportunities for participation in policy and regulatory reform as actively as they could.

Well meant strategies for institutional development in the private sector do not adequately recognize that in Kenya, local and tribal affiliations play a strong role in creating trust based relationships and that associations and groups at all levels of society are vulnerable to political interference and diversion towards tribal/ethnic interests. Kenyan political leadership reflects the preoccupation with such interests and as it matures to a sustained focus on national public good, chances are that so will the Kenyan civil society and business community.

## **7.0 MOVING FORWARD: SOME DIRECTIONS**

The purpose of policy formulation and implementation guidelines and directions charted out below is to ensure greater inclusion of those who are currently excluded by or are peripheral to present frameworks for and dynamics of economic opportunity. Kenya is on the road to reform. The formulation and implementation of pro-poor policies can be monitored against some key results that reform must aim for.

The above discussion has conveyed in broad strokes what is taking place, its limitations and its potential. The scaling up of successful pilots which can now be found on the economic landscape but usually within donor docket, requires a supportive policy environment, commitment to the implementation of pro-poor policies and a careful analysis of how donor subsidies can be replaced either by market derived capital or public subsidy. Either option will require active facilitation and government has the central role.

Unleashing the entrepreneurial potential of Kenya's MSEs requires that policymakers recognize that policy, legal, administrative and institutional change must result in at least the following :

- **Mainstreaming of participatory principles and gender and diversity considerations**
- **Targeting of low income and marginalised groups and facilitation of their access to land/work premises/infrastructure/financial and non-financial business support services**
- **Strategic and sustained partnerships between institutions at the community, corporate, local, provincial and central government levels**
- **Budgetary support to local institutions for local economic development**

- **Coordination of the legal, institutional and administrative interventions for economic empowerment**
- **Strengthening of the capacity of informal and formal MSE organizations to support their members' business growth**
- **Information, education and communication about all of the above**

Some directions for moving forward from the present status are outlined below.

### *7.1 Delineate and strengthen environmentally sound local economic development*

#### *Change the Local Authorities' Role from Monitor to Enabler*

The level of harassment which micro and small enterprises receive is because of their precarious status with regard to premises and business location; the ad hoc and somewhat spontaneous nature of some of the trading activities and poor or no maintenance of trading sites; vulnerability in view of entrepreneurs' limited or no knowledge of regulations affecting their business activity; and the excessive authority invested in the bylaws enforcement staff at the local level.

An immediate policy priority should be to address the anomalies at the level of local government. Many local government bylaws are derived from the colonial times and based on the principle of exclusion of the (then colonized) majority from profit making ventures. Although local licensing systems are being reviewed and reformed, rentseeking behaviour by officials towards MSEs has not been eliminated. Zero tolerance of corruption, stated government policy, remains to be enforced at all levels.

The principle of revenue generation for local authorities through licensing has to be reinforced with the recognition of and support to local government's potential for stimulating local economic development. This role can complement the local responsibilities for shelter and service delivery. In fact, it will allow local governments to open up new areas in shelter and service provision for entrepreneurship by the poor beyond the petty trade that dominates their current livelihood options.

Business and craft based organizations at all levels of society can play an intermediary role channeling and attracting additional funds from donors and private players and in developing businesses, shelter and services for the poor. These organizations have the potential to become project designers and implementers and if supported with capacity development, even contractors for delivery of public services. Such organizations can also facilitate dialogue between communities and different levels of government with regard to decisions related to land allocation, infrastructure and other essentials of the service delivery process.

Local government vision is essential to the potential use of local community based entrepreneurial organizations in the provision of shelter and services most especially

for the urban poor.<sup>36</sup> Action on this lies squarely with the Ministry of Local Government and the higher echelons of political decisionmaking. Political leadership must also respond to advocacy by informal businesses for the resolution of the contradictions in administrative authority of the provincial and local administration over local areas.

*Create environmental awareness and develop appropriate workplace regulations*

Compliance to standards of public health, safety and environment are presently applied in an ad hoc manner or not at all. Some systematic procedures arrived at in consultation with MSE owner operators and cognizant of affordability and relevance can be adhered to. A cleaner environment will be supportive of informal businesses in that health and sanitation benefits will accrue but also in that the proximity of informal businesses in residential and business areas could become less objectionable. The Nairobi Central Business District Association and the National Environment Management Authority could provide leadership in developing appropriate environmental guidelines by calling together a stakeholder group for outlining key issues for discussion and then addressing these in a participatory manner. Some gradation in the kind of environmental guidance and regulation appropriate for different kinds of enterprises and the cost of it to the enterprise has to be worked out.

*7.2 Utilize public subsidy strategically to enhance pro-poor access to production factors, market information and production and business related R and D*

*Earmark resources towards pro-poor access to land, work premises, skills and technologies*

It is crucial that there be clear thinking and decision making with regard to where subsidy is placed in the development and delivery of pro-poor interventions. Although there is much rhetoric about leaving the private sector to entrepreneurs and the enabling environment to the government, there continues to be a huge amount of donor funds available in Kenya for private sector capacity development. These funds are being delivered through both government and NGOs for sector specific reforms, for addressing labour and employers' organizations, for creating more supportive business environments and for market and skills development. Some of these funds could also be used to provide strategically placed subsidy to develop the capacity of MSEs to move up from the low value entrepreneurial activity; these could mean subsidized access to technologies and business premises and the earmarking of land for informal businesses.

It is the not-for-profit sector which has engaged most actively in capacity development of the poor in even the remotest areas of Kenya and supported their engagement in market systems in a way which offers them profits. This engagement

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<sup>36</sup> See Kapila S., "The Role of Civil Society in Mobilizing Finance for Low-income Shelter", a background paper for the 2005 Global Report on Human Settlements, UNHABITAT, 2005.

is limited in scope and sustainable only as long as the donor of any specific project chooses to support it. Public education and training systems and private sector commodity specific initiatives will have to step in to pick up from demonstrated success of building the capacity of small producers so that they are able to link to profitable markets. There is some movement in that direction through recently announced revival of village polytechnics (VPs) but past history of the VPs and their peripheral relevance to the world of work must not be repeated. The delivery of business related education in especially the more remote areas and the most marginalized groups requires subsidy either from the State or assured continuation of the present support of donors.

### *Support Research and Development (R and D) and market information systems*

Kenya has some agricultural and industrial research facilities that depend as much (and in fact maybe even more) on donors as on the State to fund their exploration and experimentation. The State must find ways to attract/generate funds and technical expertise in an ongoing way for the R and D which would be of benefit to producers, manufacturers, traders and consumers. Policy must recognize and support this imperative.

Beyond the R and D, information dissemination of the results of R and D is equally important. Small farmers and producers mostly rely on radio and word of mouth to access their business and production related information. The role of information as a public good cannot be overstressed. It remains the one public service which is perhaps the most ignored by those who could offer it. Kenya's business environment is particularly poor in documentation and information sharing. Unless improved information flows and market intelligence becomes a more common phenomenon, the poor will remain price takers even though their role as the primary produce suppliers could make them the price setters. Improved information and knowledge sharing systems would also contribute to addressing the distrust and disjointedness that has characterized the Kenyan economy in recent years.

Also related to R and D is the question of patenting of innovations of the informal sector. Traditional designs and products have found their way to plastic/synthetic replicas across the globe without any noticeable hue and cry from the Kenyan authorities. Some form of easy to reach and easy to decipher patenting procedures must be developed with the participation of MSEs.

### *7.3 Build Local Knowledge, Technical and Business Management Skills and Membership Organizations for Small Scale Entrepreneurship*

*Facilitate public-private-community dialogue on vocational education and technical and business related training; glean policy and program design from this*

Kenya has not had a manpower survey in several decades and it has no clear human resource development strategy. How to design educational systems responsive to the world of work has been a debate in Kenya's educational institutions for decades. No

**conclusive directions have yet been charted or success from educational reforms such as the vocation-oriented 8-4-4 school system demonstrated. There is at present no obvious node of responsibility for the identification, mobilization and coordination of private, public or community players for skills development especially at the local community level. Most of the self-employed and unemployed have a low skill base and illiteracy is a common problem. Policies and practices are still using standard prescriptions on vocational and technical training and are not able to develop or deliver skills matched to expanded opportunities. Multifaceted business training and financial education is available mainly through tertiary level institutions difficult for most small and micro entrepreneurs to access or afford. Therefore issues of appropriateness, availability, accessibility and affordability still remain urgent in the education and skills development areas.**

**Education, science and technology policies and government budgetary support is required for the delivery of integrated packages designed to address the practical realities of the businesses of the poor and how these can be changed for better response to market opportunities. The youth also need support both from public institutions and the business world to chart their entrepreneurial beginnings and to acquire the requisite skills. It could be that such support will continue to be given instead by NGOs and donors but the onus of responsibility really needs to be in the hands of public-private partnerships. Until such partnerships strategize together on the capacity development agenda and how best to contribute to it, the world of business will not fully benefit from the potential of the small producers and traders.**

**The involvement of businesses at all levels in defining what knowledge and skills are required and need to be generated is important. Their input is also vital to defining acceptable standards of technical training and qualifications. Clusters and associations at the level of small and micro enterprises can provide a decentralized organizational structure available for skill development. Both sector specific knowledge and generic business management and financial skills could be delivered through these. However, principles of good governance have to be instilled into the management of MSE associations before they can become service providers to their members.**

***Define, support and monitor the role of business organizations and private business service providers in business development***

**Legally registered institutions close to the people, institutions they understand and accept, are developing all over the country. The pulse of social capital is at the level of the self-help group and the community based organization. The poor who have had the benefit of engaging in private sector development projects are recognizing their leveraging ability as key suppliers and producers and the potential of grouping together as economic players. Through this, new confidence and business networks are emerging. In the larger urban areas and small towns in rural areas, private service providers are emerging to complement the role of NGOs but quality control and a “fit” with existing business service demand remains to be established. Some**

form of quality vetting on the kind of services that business organizations or private providers give to members and clients is needed so that organizations' members and service consumers are given value for money and not cheated through sub-standard or irrelevant service provision. If the Private Sector Development Strategy for Kenya were to embrace as it might, a value chain approach to sectoral development in the economy, then sector specific oversight should be designed.

#### ***7.4 Broaden Access to Financial Services and Support Innovation in Financial Products***

***Create awareness about the way the poor use credit and the way formal institutions disburse credit***

Kenya's microfinance industry is quite robust at the level of the top tier MFIs but more dishevelled at the lower rungs. Although a few million Kenyans have now got access to credit and savings facilities through mechanisms entirely absent or very rare twenty years ago, there are still millions who do not. They are restricted by the lack of information about what is available (many of the MFI clients are actively recruited through awareness campaigns run by credit officers), by very limited financial literacy and by nervousness about engaging in financial transactions which might put at risk their meagre possessions.

The MSEs' lack of awareness of formal financial processes and requirements is matched by very limited knowledge in financial institutions of the way the poor earn their living. The poor diversify incomes to create social security and usually cannot follow strict repayment schedules because their earnings, especially in the rural areas, are seasonal. Both financial service providers and the service consumers have to invest in learning about and adapting to the other. There is donor dependence in meeting the cost of such dialogue and ensuing product innovation but local recognition of the merit in this and public-private investment in it is long overdue.

***Make legal and administrative processes for the processing of collateral cheaper and faster***

While social collateral has worked well in MFIs and the banks which have graduated out of the MFIs, it is not a panacea for all situations. The fact that there is no legal recourse in the face of default by a group member is an issue to be addressed. Currently any civil law action against defaulters has costs which are entirely prohibitive for the smaller businesses. Paralegal options need to be devised. The issue of group facilitation falls into the challenge for organizational innovation and streamlining that is currently the mandate of NGOs.

Banks and MFIs are increasingly complementing social collateral with other forms of collateral such as business assets and land. However the processing of conventional collateral is ridden with bureaucratic delays and legal costs which undermine the use of business opportunities which may be available at any

particular time. For example the preparation and authorisation of debenture documents can take up to or more than three months, time within which the opportunity may well have passed.

*Learn from and scale up the financial innovation being done by NGOs*

For the most part, there is incompatibility between the formal and informal financial and organizational systems which makes viable relationships between them difficult. There has to be serious commitment to the design of pro-poor financial institutions in the formal sector.<sup>37</sup> These are at present the MFIs and the MFI based banks but their outreach needs to be expanded. The institutional innovation which is going on and which is heartening is being done by the NGOs. NGOs have proved themselves indispensable in mobilizing the commitment, knowledge, skills and savings of poor communities and in linking these to the formal sector and in creating greater understanding of the reality within which informal businesses operate.

NGOs have been able to facilitate some degree of risk mediation of the lenders using strategies illustrated through some of the examples in this paper. Value chain financing could become more mainstream if value chains could be better integrated and managed. There are small beginnings. The challenge of linking larger financial institutions to credible NGOs and through them to small producers in order to deepen financial access poses once again the question of what can replace the role of donor subsidy used in the facilitation of the linkage and the development of an innovative loan product.

Domestic capital can be mobilized for the support of MSEs if the risk of lending to them can be mitigated through interventions at strategic points in the financial markets. For example, the use of government/ donor guarantees for loans from the larger banks to MFIs. Wholesale lending to the larger MFIs is a viable proposition and creates sustainable links between formal and informal, large and small. The use of tax incentives and the delineation of priorities through some public debate for the use of corporate responsibility funds should be explored. At the moment, even donations from private sector to smaller businesses or institutions are subject to taxation. This is likely to inhibit the small beginnings in local philanthropy which could complementing donor funds which have been the springboards of MFI development. The example of other countries where policies to support MSEs through corporate responsibility schemes might have shown some results should be studied. Such initiatives need to be analysed, learnt from, adapted and mainstreamed.

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<sup>37</sup> The author has drawn this emphasis from the observations of Baumann T.,(2001) “ Bridging the Finance Gap in Housing and Infrastructure”, on the website [www.theinclusivecity.org](http://www.theinclusivecity.org)

## **7.5 Open Up New Markets**

***Make “Infrastructure for All” a national slogan !***

**In many parts of Africa, and Kenya is no exception, the poor are excluded from market opportunities both geographically and culturally. Their inclusion requires long term, multifaceted interventions.<sup>38</sup> This takes political commitment and a detailed program of facilitative action in market systems so that over time the market itself can provide most of the solutions to the problems of the businesses of the poor. Information and infrastructure are the public pillars on which private sector activity can be encouraged to develop a pro-poor focus. Agro-processing, manufacturing and wholesaling in both urban and rural areas has potential still untapped; basic physical infrastructure is essential to unlocking it. The more marginalized people in the norther districts of Kenya are vocal about how they have been “marginalized by policy” which has consistently overlooked the desperate need for water and roads essential to their survival and connection with the more lucrative southern markets.**

**Infrastructure in the form of roads, water and sanitation systems, electricity, and telecommunications is inadequate all over Kenya particularly in the rural areas. The ASAL people are affected most by this lack and this is obvious from their levels of poverty.**

***Maintain a firm policy stand on the reduction of tariff barriers***

**The formal sector is likely to be more responsible and generous towards the capacity enhancement of the informal as its own present and future improves. The informal sector has grown as the formal has shrunk. As the formal expands, more employment opportunities and links to the self-employed could be forged, if supported by policy and public guidance. For the formal large businesses to grow, bigger markets and lower production costs are essential. Government is key to this. Together with other countries, Kenya has to lobby against the barriers put up by the industrialised countries in the global marketplace. Closer to home, the government must play a stronger role in opening up regional markets and bring to realization the East African common market. It should find ways to offer the Kenyans some of the subsidies their competitors in neighbouring countries do. It should then ensure that MSEs get a share of the benefits of growth.**

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<sup>38</sup> Kapila S. and Mead D., editors, *Building Businesses with Small Producers: Successful Business Development Services in Africa, Asia and Latin America*, ITDG and IDRC, London and Ottawa, 2002.

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- **6% GDP growth has not translated into a reduction in poverty in Kenya**
- **The overwhelming majority of private sector economic activity takes place in the informal economy**
- **In 2006, employment in the informal sector was estimated at over 6 million persons in comparison to formal sector wage employment estimated at just under 2 million <sup>39</sup>.**
- **Current legislation allows local authorities considerable discretion in the licensing of small-scale business activity. This is where petty corruption has been pervasive adding to the costs of the informal entrepreneur.**

**More than half of Kenya's population, 57%, continue to live below the poverty line.<sup>40</sup> This is equally true of both the rural and urban areas.**

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<sup>39</sup> Government of Kenya, *Economic Survey 2006*, The Government Printer, 2006, Nairobi.

<sup>40</sup> Kimalu P. et al, *A Situational Analysis of Poverty in Kenya*, KIPPRA Working Paper No.6, Kenya Institute for Public Policy Research and Analysis, Nairobi, 2002.