Integrating SMEs in the Devolved Government System; Policy Options for Institutional and Regulatory Framework in Kenya

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EXECUTIVE SUMMARY

Small and medium-sized enterprises (SMEs) are an important sub-sector for the Kenyan economy. It employs about 85 percent of the Kenyan workforce (about 7.5 million Kenyans of the country's total employment). The current constitution provides a new window of opportunity to address SME-related issues through regulatory and institutional framework under the devolved government system, as well as the new SME Act.

This study has assessed the existing and potential institutional and regulatory challenges, which might be a bottleneck to the revitalization of SMEs at the county level. Participatory Competitive Advantage (PACA) methodology has been adopted to collect the primary data in Homabay, Kwale, Kiambu and Bomet counties to inform the analysis.

Case studies of Irish potatoes, dairy, fishing, pineapples and oranges were used to understand the various institutional and regulatory challenges facing SMEs in Kenya.

The findings depict various institutional and regulatory challenges facing the SMEs in Kenya. These include poor coordination of the SMEs activities, inadequate private and public dialogue at the county level, poor enforcement of regulatory legislations, and a knowledge gap on national and county policies interface.

The study recommends there be an inclusive private-public dialogue, stronger business associations at the county level, specific county-led SMEs policies aligned with the overall SMEs policy, tailored training institutes for SMEs at the county level, established SME-oriented financial institutions in each county, established import and export bank for SMEs, central government to coordinate the SMEs issues in the country, established SME development organization, established entry-level for SMEs groups, and cross-county knowledge sharing and field experiences.

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INTRODUCTION

SMEs have the capacity to achieve rapid economic growth, while generating a considerable extent of employment opportunities (Reddy, 1991). SMEs create about 85 percent of Kenya's employment (African Economic Outlook, 2011 report[1]). While the subsector constitutes almost 85 percent of employment, it only contributes to about 20 percent of the total GDP. This implies dismal performance for the subsector, despite its potential contribution to employment, income and equity in Kenya. The development trajectory of the subsector thus requires a system that holistically fosters SME development. The current constitutional framework and the new SME Act provide a window of opportunity through which the evolution of SMEs can be realised through the devolution framework. However, the impact on devolution on SMEs development depends on the architecture of the regulatory and institutional framework inclined to support SMEs in an economy (Kiggundu, 2000). It is against this background that this study was undertaken, to assess the regulatory and institutional framework in the SMEs subsector vis-a-vis the emerging devolved government system in Kenya.

METHODOLOGY

Scope of the Stud

The study was conducted in Homabay, Kwale, Kiambu and Bomet counties. Case studies of Irish potatoes, dairy, fishing, pineapples and oranges were used to understand the various institutional and regulatory challenges facing the SMEs in Kenya. [See table 1].

TABLE 1: Aggregation of Subsectors and Counties

COUNTRY	SUBSECTOR
Kiambu and Bomet	Dairy and Irish potatoes
Homabay	Fishing and pineapple
Kwale	Oranges and fishing

Data Collection and Analysis

The research team examined relevant documentation, which included reports, various policy documents and Internet sources to collate the secondary data. The review also included a comparative case analysis on the regulatory and institutional practices for more advanced economies in SMEs development, like India and Republic of South Africa (RSA). The study adopted the Participatory Competitive Advantage (PACA) methodology to collect the primary data. The focus group discussions in the PACA framework were conducted in Homabay, Kwale, Bomet and Kiambu counties. A total of 30 participants were engaged in each of the focus group discussions where each subsector had 15 members in every focus group discussion. The sample for the focus group discussion was drawn from the small-scale farmers and producers, farmer groups and associations, and the relevant government ministries from the respective subsectors. Further in-depth interviews were conducted with the key informants, where predetermined questionnaires were administered. Common policy positions were deduced from the fieldwork findings and literature review analysis.

> **It would be important for the government to establish SMEs specific training institutes, especially in each county, based on the county's competitiveness and its production output.**

KEY FINDINGS

Production Challenges

Comparative analysis across the five subsectors confirmed common production challenges ranging from inadequate inputs and production technology to enhance good crop and animal production husbandry. The production challenges were attributed to limited access to finance by the SMEs, despite the existence of various financial institutions meant to cater for SMEs financing in the country. The limited access to finance is attributed to stringent conditions set by the financial institutions. For instance, the Kenya Industrial Estates requires that the SMEs should be in a registered association or group to be able to access loans. However,

1 See http://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/Kenya%20Full%20PDF%20Country%20Note.pdf

most of the SMEs do not qualify to access the loans, as they do not belong to any of the producer associations. Comparative analysis in the case of India and RSA is contrary to the situation in Kenya. For instance, there is the South Africa Micro Finance Fund and the Small Industries Development Bank in South Africa and India respectively. The Indian government has also established the Export-Import Bank to assist the SME units in establishing their products in international markets. These two institutions are meant to promote access to finance among the SMEs.

Marketing and Value Addition Challenges

The implication of limited access to finance was also affirmed by various participants to have various implications on marketing and value addition challenges, where the cross-cutting challenges, like the high cost of acquiring cooling plants/processing materials; inadequate processing and storage facilities, were attributed to limited access to finance by farmers. Most farmers are not able to access credit to acquire relevant equipments to facilitate value addition activities. The other challenges that have contributed to low value-addition activities include limited trainings facilities on farm production, inadequate entrepreneur skills and limited technical knowhow on processing. It was also felt that most SMEs do not have the relevant skills to facilitate value addition activities, thus promoting exploitation by middlemen who buy unprocessed produce.
It was also established that the Kenya Industrial Research and Development Institute (KIRDI) impacts on value-addition are yet to be realised in most of the counties in Kenya, as farmers still market unprocessed produce at a relatively low price. For instance, participants felt that KIRDI has not realised its expected role in enhancing value addition led technologies to activities related to horticulture.

REGULATORY AND INSTITUTIONAL CHALLENGES

(a) Poor Coordination of the SMEs Activities:

Closer analysis of the key study findings and literature review confirms existence of multiple institutions and departments handling SMEs issues, which regulate the subsectors. For instance, the Ministry of Trade, the Ministry of Industrialisation and the Ministry of Labour have departments working on similar issues on SMEs. This has contributed to limited focus in terms of coordinated strategies and approaches to stimulate SMEs development in Kenya. However, the scenario is contrary in the case of India and RSA. For instance, the Ministry of Micro, Small and Medium Enterprises in India and the Department of Internal Trade and Industry in South Africa are responsible for the overall coordination of the SMEs activities in the Department of Internal Trade and Industry. Furthermore, the two countries have specific SMEs legislations that guide the operation of the SMEs activities.

> **The government should also consider establishing an import and export bank for SMEs. Such bank should focus on SME exporters as a significant target group of clients.**

(b) Inadequate Private and Public Dialogue at the local (County) Level:

Even though the private–public dialogue has been emphasised at the central level, through the Kenya Private Sector Alliance (KEPSA), most stakeholders cited limited consultation at the ground level during the policy making process. The limited consultation was attributed to lack of stronger sector specific associations at the local level. Some of the existing associations are weak and lack funding to advocate for the policy-related reforms in the respective subsectors. On the other hand, a comparative case analysis from India and RSA affirms a formal institutional structure for SMEs development. The existing regulatory structure depicts institutionalised systems for private and public dialogue for SMEs consultation, framework for stronger SMEs association and stronger institutional linkages and coordination.

(c) Poor enforcement of regulatory legislation:

The findings affirm limited coordination in the implementation of the regulated policies for SMEs in Kenya. For instance, the implementation of the Legal Notice No.44 in the potato industry has been inadequate due to limited coordination between the Ministry of Agriculture and the Local Authorities in the respective counties. The same scenario is also evident in the fishing industry where the implementation of the regulation on the beach management units has not been realised as per the intended objectives. There are also institutional challenges in regulation of the dairy industry, where the regulator (Kenya Dairy Board) does not have intensive presence at the county level.

(d) Knowledge gap on National and County Policies Interface:

In terms of how the regulatory agents will relate to the county system of government, it was found that there is a large gap in thinking on how and in what manner the national agencies will relate and have a presence in the counties. However, the extent to which the new county system contributes to SMEs development in the respective counties depends on how best the current SMEs Act is restructured to factor in the administrative changes as outlined in the current constitution of Kenya.

IMPLICATIONS AND POLICY RECOMMENDATIONS

The research findings from the field affirm common challenges facing the SMEs in the respective counties and subsectors. The challenges range from production, marketing, institutional and regulatory. Most of these challenges are county specific, which implies that each county is unique in terms of economic activities. However, the challenges are common on the basis that most of the counties are characterised by agricultural- related activities. The challenges require a strategy that would promote easy access to credit and farm inputs, promote value addition activities and establish an effective institutional and regulatory framework. Discussions with various stakeholders confirmed various potential in enhancing sustainable development through relevant institutions to enhance value addition activities at the local level. Other key policy issues arising from the research findings are pegged on the fact that there is a lack of a formal institutional framework, both at the national and local level. The institutional deficiency has contributed to unclear consultation mechanisms at the local level between the private sector and the government.

Policy Recommendations

The new Constitutional dispensation and the institutional framework proposed under the new SME Act are important developments that can help the evolution and success of SMEs. There is a wide range of programmes in diverse areas of SME development, such as financing, technology, innovation, managerial ability, market information, and developmental assistance, aimed at improving the working environment for SMEs. In the context of Kenya, SME development requires a cross-cutting strategy that touches upon many areas, which can help the sector to improve and create a niche for itself in the Kenyan economy. A set of measures has been suggested, in terms of approach, policies and programmes for SME development in Kenya. The following are the proposed policy recommendations that should be adopted to address the SMEs-related challenges in line with the key study findings;

a) Establish an inclusive Private-Public Dialogue:

A formal and organised SMEs structure would provide direction on how the county government should establish a formal coordination structure. These could include national consultative panels; regional and local panels; explicit and open policy development processes; and transparent government activities. Supportive government institutions evidenced by an operational public-private dialogue framework would provide avenues through which the SMEs associations can present their interest at the county level through the county assemblies. Such dialogues can be enhanced through the following mechanisms.

b) Support the establishment of stronger business associations at the county level:
The overall and county specific government policies for SMEs should emphasise building alliances in the various SMEs subsectors. The government should provide support to enhance legitimate representative organisations at the county level. Such networks/ associations would assist in lobbying and policy advocacy through the county assembly and citizen fora.

c) Formulate specific county-led SMEs policies and programmes aligned with the overall SME Act:
There is need for each county to evolve its own policies and packages of incentives based on the county's economic competitiveness. Such policies should be informed by diagnostic studies undertaken to understand the respective county competitiveness. The revealed county competitive advantage would indicate the SMEs sector, which the county government should promote. However, for the sake of stronger coordination, the central government should remain to be the overall overseer of all the SMEs strategies in each county to assist in the promotion of the SMEs activities.

d) Establish tailored training Institutes for SMEs at the county level:
Even though there are government institutions providing courses on SMEs issues, it would be important for the government to establish SMEs specific training institutes, especially in each county, based on the county's competitiveness and its production output. Such training for SMEs should focus on developing and providing training, research and consulting services for small-scale entrepreneurs to enhance production, value addition and entrepreneurship skills.

e) Establish SME oriented financial institutions in each county:
There is need for specific SME-oriented banks to facilitate the promotion, financing and development of a small-scale industries sector. The financial institution should also offer a wide range of financial products, either directly or indirectly. The financial institution for SMEs should be established in each county to enhance easy access for potential and existing SMEs.

f) Establish an import and export bank for SMEs:
The government should also consider establishing an import and export bank for SMEs. Such a bank should focus on SME exporters as a significant target group of clients. The bank should proactively assist the SME units in establishing their products in international markets and developing the markets within the value chain.

g) Central coordinating institution:
The proposed Micro and Small Enterprises Authority under the SME Act should focus on policy articulation, promotion, development and protection of SMEs. It should also monitor the execution of the formulated policies to monitor the effectiveness in their implementation. It must work directly with the relevant departments at the county government and should facilitate the establishment of a SMEs One-Stop-Centre where all the national issues regarding SMEs are addressed.

h) Establishing an entry level for SMEs groups:
The government should develop requirements and criteria for SMEs operations where strict regulations for SMEs entry and exit should be established to ensure that only the skill-based SMEs are permitted to operate in the market.

i) Cross-county knowledge sharing and field experiences:
The comparative analysis on the study findings confirms diversity in terms of resources, experiences and subsector performance. There will be a need to promote equitable regional competitiveness through cross-county collaboration by sharing experiences and skills through field visits..

CONCLUSION

This study has shown that there are differences in county-specific and sectoral needs by SMEs in Kenya. These supportive needs across the different value chains must be provided. Even though the new institutional structure of the county government after the recent elections is now a reality, it is generally agreed that its full operationalisation will take some time. Meanwhile, there will be need for the Transitional Authority to work closely with the newly established Small and Medium Enterprise Development Authority, in Kenya to identify county and value chain specific needs of SMEs. It is only by recognising this that SMEs will be able to efficiently provide a source of employment and income for millions of Kenyans.

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