Policy Brief

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SMEs Development in the Devolved Governance System

Policy Options for Institutional and Regulatory Reforms in Kenya

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Small and Medium Enterprises (SMEs) is an important sub sector for the Kenyan economy like many other developing countries, since 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 SMEs related issues through regulatory and institutional reforms under a new, devolved governance system as well as the Micro and Small Enterprises Act 2012. CUTS undertook a study to assess existing and potential institutional and regulatory challenges which impede SME development, at the county level. Evidence was gathered from SMEs engaged in the following sectors: Irish potatoes, dairy, fishing, pineapples and oranges, to build the evidence base. It emerged that current challenges include poor coordination of the SMEs activities; inadequate private and public dialogue at the county level; poor enforcement of regulatory legislations; and knowledge gap about national and county-level policies' interface.

The study recommends the need to initiate inclusive private-public dialogues; support the establishment of stronger business associations at the county level; formulate specific county led SMEs policies aligned with the overall national SMEs policy framework; establish tailored training institutes for SMEs at the county level; develop SMEs oriented financial institutions in counties; establish an import and export bank for SMEs; need for the central government to coordinate the SMEs issues in the country and establish a SMEs development organisation.

Introduction

SMEs have the capacity to achieve rapid economic growth, while generating a considerable extent of employment opportunities (Reddy, 1991). The importance of SMEs in Kenya was first recognised in the International Labour Organisation report *on 'Employment, Income and Equity in Kenya'* in 1972. The report underscored SMEs as an engine for employment and income growth. SMEs create about 85 percent of Kenya's employment (African Economic Outlook, 2011 report).[1] While the subsector constitutes close to 85 percent of employment, it only contributes about 20 percent of the total GDP. This implies dismal performance of the subsector. The development trajectory of the subsector thus requires a system which holistically fosters SME development.

The current constitutional framework and the new Micro and Small Enterprise Act 2012 (MSE Act, 2012) provide a window of opportunity through which the evolution of SMEs can be realised through the devolution framework. However, the impact of 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 thus imperative to appraise the regulatory and institutional framework for SMEs given the existing devolved government system in Kenya. 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 governance system in Kenya.

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

Methodology

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.

Table 1: Subsectors and Counties

County	Subsector
Kiambu and Bomet	Dairy and Irish potatoes
Homabay	Fishing and pineapple
Kwale	Oranges and fishing

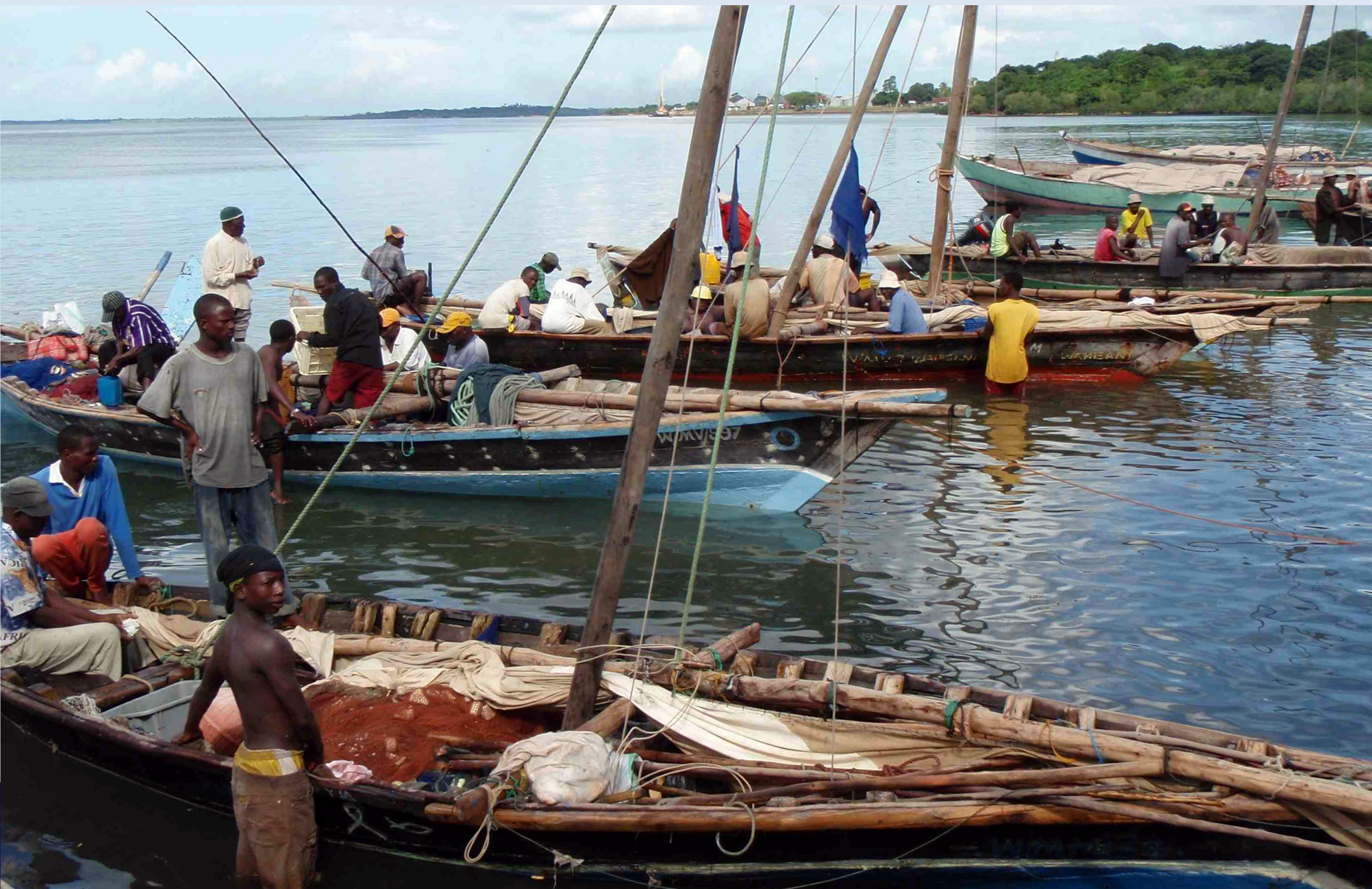
The research team examined relevant secondary documentation which included reports, various policy documents and internet sources. The review also included a comparative case analysis of more advanced economies in SMEs development like India and Republic of South Africa (RSA). The study adopted the Participatory Competitive Advantage (PACA) methodology to collect the primary data**.** Focus group discussions were conducted in Homabay, Kwale, Bomet and Kiambu counties. In-depth interviews were held with key informants through questionnaires. Common policy positions were deduced from the fieldwork findings and literature review analysis.

Findings

Production Challenges

Comparative analysis across the five subsectors confirmed common production challenges like inadequate inputs and lack of production technology for better crop and livestock production. Production challenges were attributed to limited access to finance for SMEs, despite the existence of various financial institutions. This was primarily due 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, 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 placing their products in the international markets.



Marketing & 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. High cost of acquiring cooling plants; processing infrastructure and storage facilities were cited by farmers. Other challenges include limited trainings facilities on farm production, inadequate entrepreneur skills and limited technical knowhow on processing.

It was also felt that most SMEs players do not have the relevant skills to facilitate value addition activities, thus promoting exploitation by middlemen. 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 relatively low prices.

Regulatory & Institutional Challenges

(a) *Poor coordination of SMEs activities*: Closer analysis of the key study findings and literature review confirms existence of multiple institutions and departments handling SMEs issues in Kenya. For instance, the Ministry of Trade, the Ministry of Industrialisation and the Ministry of Labour have departments related to SMEs. There is lack 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 designated line ministries responsible for the overall coordination of the SMEs related activities in these countries.

(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 policy making processes. Such limited consultation was attributed to lack of strong sector-specific associations of SMEs at the local level. Some of the existing associations are weak and lack funding to participate in relevant policy related discussions. 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 system for private and public dialogue for SMEs consultation, framework for stronger SMEs association and stronger institutional linkages and coordination.

(c) *Poor enforcement of regulatory legislations*: The findings affirm limited coordination in the implementation of the SMEs-related programmes and policies 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 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.

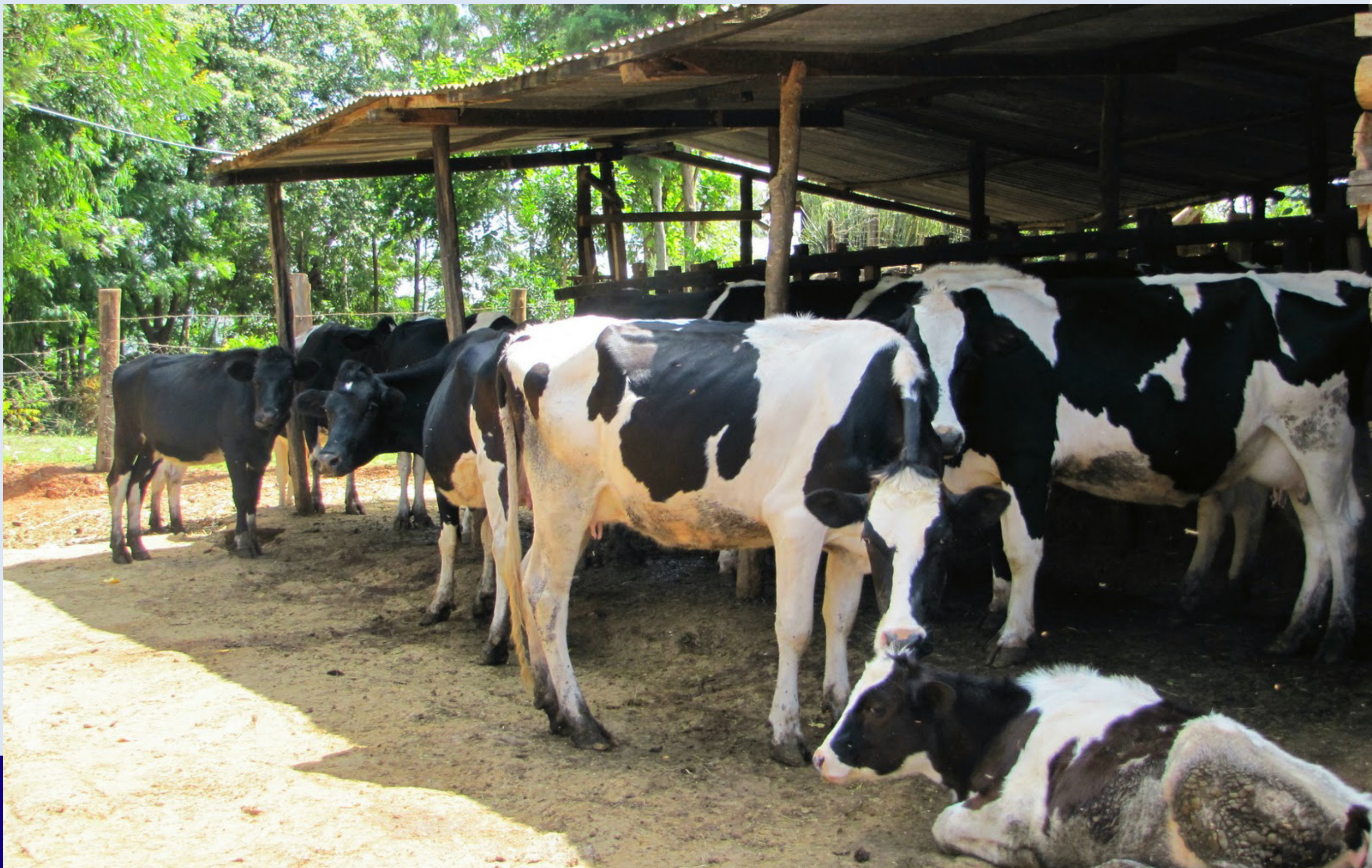
(d) *Knowledge gap on National and County policies' interface*: The extent to which the new county system contributes to SMEs development depends on how best the operationalisation of the current MSE Act, 2012 factors in the necessary administrative changes as outlined in the current Constitution of Kenya.

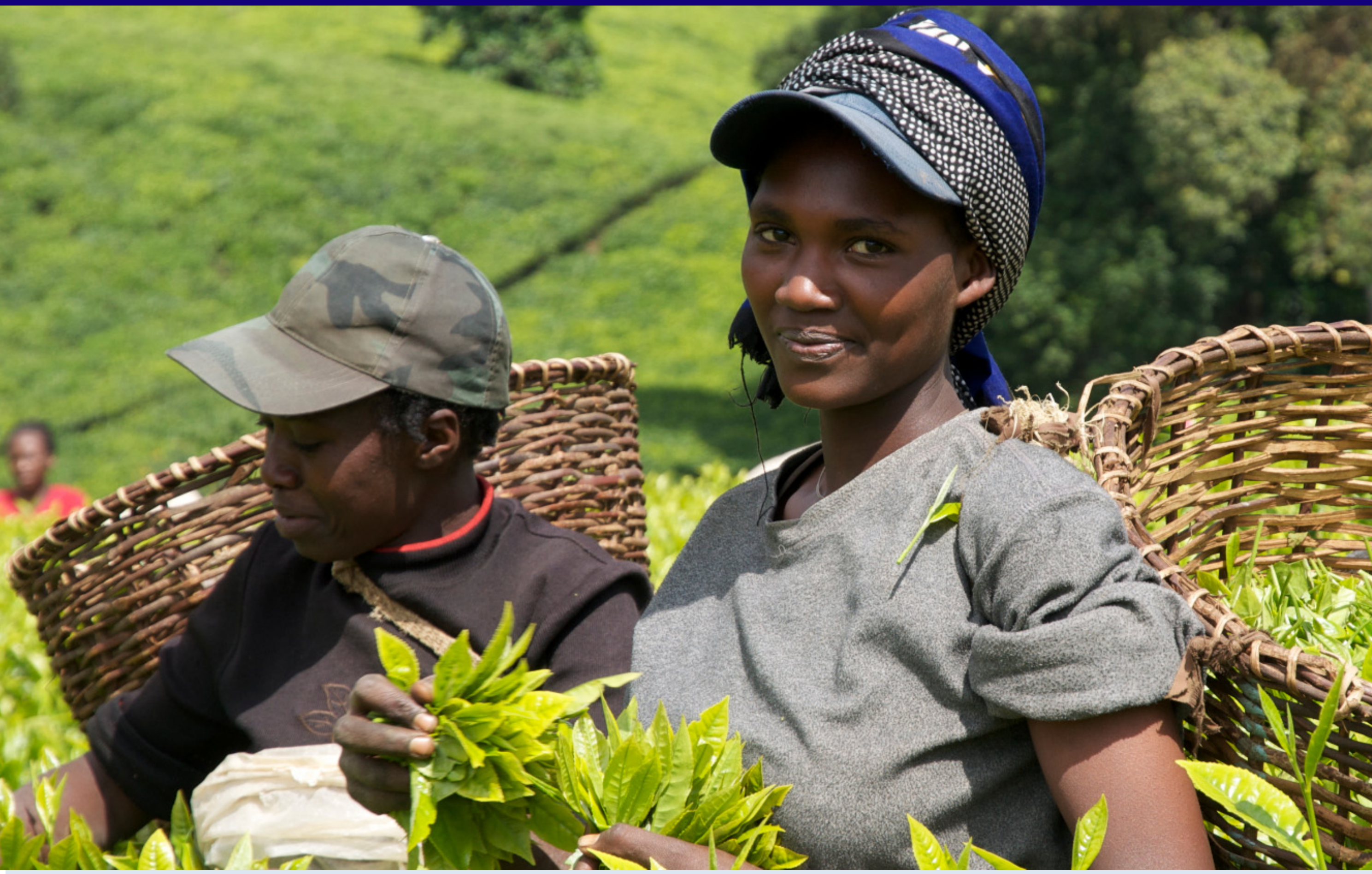
Implications and Policy Recommendations

The research findings from the field affirm common challenges facing the SMEs in the counties and at sub-sector level. The challenges are related to production, marketing, institutional and regulatory issues. Most of these challenges are county-specific in nature. However, the challenges are also common especially in those counties that are dominated by agricultural activities.

The challenges require a strategy that would promote easy access to credit and farm inputs, promote value addition activities and establish a well-coordinated and effective institutional and regulatory framework. There is also a gap in terms of information available regarding the operationalisation of certain institutions/agencies at the country level.

Other key policy issues arising from the research findings are pegged on the fact that there is lack of a formal institutional framework both at the national and local level, dedicated to SMEs development. The institutional deficiency has contributed to unclear consultation mechanism 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 SMEs Act are important developments that can lead to further evolution and success of SMEs in Kenya, if properly implemented. Some of the findings and related recommendations of this report will help in such actions.

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 in this regard has been suggested below:

- **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.

- **Support establishment of strong SMEs associations (county level)**: The overall and county specific government policies for SMEs should emphasise on building alliances in the various SMEs sub sectors. 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 citizens' fora. Associations of SMEs engaged in the same product should be promoted, especially at country levels.

- **Formulate specific county led SMEs policies and programmes**: 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 identify the 'competitive advantage' of a particular county in the SMEs sector. 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.

- **Establish tailored training Institutes for SMEs (in Counties)**: 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.

- **Establish SMEs oriented financial institutions (County level)**: There is need for specific SMEs oriented banks to facilitate the promotion, financing and development of the small scale industries. The financial institution should 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.

- **Establish an Import-Export Bank for SMEs**: The government should also consider establishing an import and export bank for SMEs. The bank should focus on SME exporters as its target beneficiaries. The bank should proactively assist the SME units in establishing their products in international markets and developing the markets within the value chain.

- **Central coordinating institution**: The proposed Micro and Small Enterprises Authority under the MSE Act, 2012 should focus on policy articulation, promotion, development and protection of SMEs. It should also monitor the execution of the formulated policies and 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.

- **Establishing a single window for SMEs**: 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.

- **Cross county knowledge sharing and exchanges:** The findings confirm diversity in terms of resources, experiences and sub sector performance across different counties. There is need to promote cross county collaboration by sharing experiences and skills through field visits to understand cross county experiences.

Conclusion

This study has shown that there are differences in county specific and sectoral needs of SMEs in Kenya. These supportive needs across the different value chains should 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, Kenya to identify county and value chain specific needs for SMEs. It is only by recognising this that the SMEs will be able to efficiently provide a source of employment and income for millions of Kenyans.

References

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(Courtesy: Pictures are taken from the internet)

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