

UNIVERSITY OF NAIROBI

INSTITUTE OF DIPLOMACY AND INTERNATIONAL STUDIES

**"KENYA-SINO ECONOMIC RELATIONS: THE IMPACT OF CHINESE
INVESTMENT IN KENYA'S TRANSPORT SECTOR"**

**BY
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**A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE
DEGREE OF MASTERS OF ARTS IN INTERNATIONAL STUDIES**

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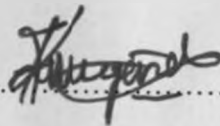
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DECLARATION

I declare that this research project is my original work and has not been presented for a degree in any other university.

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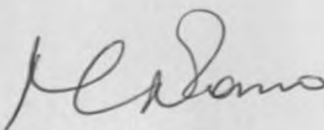
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DEDICATION

I would like to dedicate this work to my beloved children, family and friends. Thank you for encouraging me to be the best I can be.

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LIST OF ABBREVIATIONS

BPO: Business Process Outsourcing

CBR: Central Bank Rate

COMESA: Common Market of Eastern and Southern African States

DRC: Democratic Republic of Congo

EAC: East African Community

EIA: Environmental Impact Assessment

EMCA: Environmental Management and Coordination Act

EU: European Union

FDI: Foreign Direct Investment

FIEs: Foreign Invested Enterprises

FTA: Free Trade Agreement

GATT: General Agreement on Tariffs and Trade

GDP: Gross Domestic Product

GOK: Government of Kenya

ICT: Information and Communication Technology

IFC: International Financial Corporation

IMF: International Monetary Fund

IT: Information Technology

ITES: Information Technology-Enabled Services

JBIC: Japan Bank for International Cooperation

KRC: Kenya Railways Corporation

M&A: Mergers and Acquisitions

MDG: Millennium Development Goals

MFN: Most Favoured Nation

MNEs: Multinational Enterprises

NEPAD: New Partnership for Africa's Development

OECD: Organization of Economic Cooperation for Development

PPPs: Public Private Partnerships

PRC: People's Republic of China

R&D: Research and Development

ROC: Republic of China

RVR: Rift Valley Railways

SADC: Southern African Development Community

SSATP: Sub-Saharan Africa Transport Policy

TRIMs: Trade- Related Investment Measures

TTCANC: Transport Transit Coordination Authority of the Northern Corridor

UN: United Nations

UNCTAD: United Nations Conference on Trade and Development

USAID: United States Agency for International Development

VAT: Value Added Tax

WTO: World Trade Organization

ABSTRACT

The economic relationship between China and Africa has evolved noticeably over the last five years. There has been an increase in Chinese investment in Kenya particularly in the transport sector. Chinese companies have been involved in the construction of major road networks in Kenya for example, Nairobi-Thika Highway, Airport road in Nairobi, Kipsigak – Serem – Shamakhokho in Rift Valley, Kima-Emusustwi Road and Gambogi-Serem road in Western Kenya. Three Chinese companies involved in the construction of Nairobi-Thika Highway were China Wu Yi (Kenya) Corporation, Sheng Li Construction Company and Sinohydro Company.

The overall objective of this study was to determine the economic impact of international business relations between Kenya and China through construction of Thika Highway by Chinese companies. To achieve the main objective, the study sought to determine how Chinese foreign investment policies favour investments in Kenya, determine how Chinese investments in Kenyan transport sector has led to creation of employment opportunities, to establish the effects of Chinese investments on Kenyan infrastructure and its impact on gross domestic production in Kenya.

The findings of the study reveal that the existing cordial relationship between the governments of Kenya and China facilitated the award of the tender to improve Nairobi-Thika Highway to Chinese contractors. The Nairobi-Thika Highway Improvement Project has contributed to enhancement of transport services and urban mobility in Nairobi by reducing general transport costs, improving accessibility to public transportation, employment opportunities, housing, and recreation activities. In addition, the project has promoted private sector participation in the management and operation of road infrastructure in Kenya.

Therefore, the project has significant impacts on the Kenyan economy. The study recommends that: (i) Kenya invites other developed countries with favourable foreign investment policies as China's to invest in other areas of Kenyan infrastructure, (ii) Kenya puts in place investment measures and policies that will ensure that foreign investors involve more Kenyans in their work. (iii) Kenya increase bilateral trade within China and other development partners. (iv) the government of Kenya replicate similar project in other towns in Kenya and improve other modes of transport like rail, air and water.

CHAPTER ONE

INTRODUCTION

This chapter presents the background to the study, statement of the research problem, objectives of the study, conceptual framework, theoretical framework, hypotheses and research methodology.

1.1 Background to the Study

Foreign investment is prized by developing countries for the bundle of assets that multinational enterprises (MNEs) deploy with their investments. Most of these assets are intangible in nature and are particularly scarce in developing countries. They include technology, management skills, channels for marketing products internationally, product design, quality characteristics, brand names, etc. In evaluating the impact of foreign investment on development, however, a key question is whether MNEs crowd in domestic investments (as, for example, when their presence stimulates new downstream or upstream investments that would not have taken place in their absence), or whether they have the opposite effect of displacing domestic producers or pre-empting their investment opportunities.¹

The East African Community Model Investment Code 2006 defines a foreign investor to mean; a natural person who is not a citizen of partner state, company incorporated outside the partner states and if incorporated in the partner states, controlling interest lies with non citizens of partner states or partnership with the controlling interest in the hands of non citizens of partner states and who have set up an investment in the partner states.²

The partner States of East Africa also do not provide direct, clear and different definitions for FDI in their national legislations covering the areas of FDI. They rather give a general definition. For the case of Tanzania, it defines a foreign investor in Section 3 of the

¹ Agosin, M. R. and Mayer, R. (2000). Foreign Investment in Developing Countries: Does it Crowd in Domestic Investment? No.146, page 1.

² Section 2 of The East African Community Model Investment Code. July 2006.

Investment Act.³ Foreign investor is stated as “in the case of a natural person means a person who is not a citizen of Tanzania; in case of a company, means a company incorporated under the laws of a person who is not a citizen of Tanzania, and in any case in which more than fifty percent of the shares of a company are held by a person who is not a citizen of Tanzania, and in the case of partnership, controlling interest is owned by a person who is not a citizen of Tanzania; The definition doesn’t state as to when an investor is said to have a controlling interest.

However, the investment law of Rwanda⁴ gives a wider definition of foreign investor. It defines a foreign investor to mean; a natural person, a company or a partnership that invest a minimum of the equivalent of one hundred thousand (\$ 100,000) United States Dollars in foreign capital in a business enterprise to which the Investment Law applies, and is a natural person, who is not a citizen of Rwanda nor a citizen of a country which is a member of the Common Market of Eastern and Southern African States (COMESA).⁵ The definition of a foreign investor in Rwanda appears restrictive as it excludes citizens from countries who are members of COMESA. This has the effect of denying many potential “foreign investors” the benefit that is usually accorded to foreign investors in Rwanda.

The Investment Promotion Act of Kenya defines a foreign investor to mean; a natural person who is not a citizen of Kenya, a partnership in which the controlling interest is owned by a person or persons who are not citizens of Kenya or a company or other body corporate incorporated under the laws of a country other than Kenya.⁶

1.1.1 Strategic Partnership between Africa and China.

The relationship between China and Africa has evolved noticeably over the last five decades and three separate periods can be distinguished within this timeframe. Initially, relationships were established between China and African nation states as they gained independence. Then came the period when China was given a permanent seat on the UN

³ Tanzania Investment Act, 1997.

⁴ Investment Code Article 1 (f) of Law No 14/98 of 18/12/1998 Establishing The Rwanda Investment Promotion Agency.

⁵ Investment Code Article 1 (f) (i) of Law No 14/98 of 18/12/1998 Establishing The Rwanda Investment Promotion Agency

⁶ Section 2 of the Investment Promotion Act, 2004.

Security Council in 1971. The final phase covers the post-Maoist period and is characterized by the liberalization and subsequent growth of the Chinese economy.⁷

China's relationship with Africa started to develop in the early 1950s. Before 1955, Africa was of no significant importance to China but from then onwards, China sought international recognition and political allies, hoping to strengthen international alliances against the capitalist West and the revisionist communist Soviet Union.⁸

During the Bandung Conference held in 1955, China and the African states adopted the five principles of 'Peaceful Coexistence' that had earlier been formulated by India and China. These covered (1) mutual respect for sovereignty and territorial integrity; (2) mutual non-aggression; (3) non-interference in each other's internal affairs; (4) equality and mutual benefit; and (5) peaceful coexistence.⁹ Following the conference, China supported African countries with economic, technical and military support in an attempt to restrain the dominant western powers and create a new political and international order. African states were at the same time seeking allies to help them win their fight for independence and financial support to fund these struggles. From 1966 to 1969, Chinese attention towards Africa was diverted due to domestic changes and the great proletarian Cultural Revolution. After internal disputes had been settled, China began to establish new relationships on the African continent.

The People's Republic of China (PRC) and the Republic of China on Taiwan (ROC) have always competed for political recognition. In 1971, the PRC replaced the ROC on the United Nations Security Council as the 'legitimate China'. From then onwards, the PRC won recognition from many states, leaving the ROC with less international support. In the early 1980s, there were only 22 states worldwide that recognized the ROC, and the PRC became a strategic partner for international issues. Alliances were subsequently formed.¹⁰

⁷ Wright, R. (1956) 'The Color Curtain', in D.J. Muekalia (2004), 'Africa and China's Strategic Partnership', *African Security Studies*, 13 (1): 5-12.

⁸ Wright, R. (1956) 'The Color Curtain', in D.J. Muekalia (2004), 'Africa and China's Strategic Partnership', *African Security Studies*, 13 (1): 5-12.

⁹ Ibid.

¹⁰ Liu, P. (2001) 'Cross-straight Scramble for Africa: A Hidden Agenda in China-Africa Cooperation Forum', *Harvard Asia Quarterly*, V (2): Spring.

With more than 50 states in Africa, there have been opportunities for both the ROC and the PRC to establish alliances. Africa was seen as a battleground when it came to establishing diplomatic relations. With aid programmes and loans, the two governments sought partnerships and thus recognition. From the 1990s onwards, competition increased dramatically. The foreign policies of African countries have for a long time been driven by the search for aid and substantial financial contributions have often determined the choice made by African governments in this respect. However, relations can easily change. For example, Liberia, Senegal and the Central African Republic have switched allegiances at least five times in the past.¹¹

China's relations with Africa have been characterized by aid agreements. In the struggle for independence in Africa, China was willing to assist the new nation states with prestigious projects, emphasizing that it had given all it could in terms of financial and technical resources.¹² China's strategy was simple: it was trying to cultivate as many allies as it could and maintain old friendships. As mentioned in the previous section, the ROC was also assisting African countries and competition between it and the PRC emerged.

China supports a number of African countries with direct aid. Three major themes can be distinguished: building projects; Chinese medical teams; and scholarships for Africans to study in China. China has assisted Africa with numerous projects, the largest of which was the construction of the 1800-km Tanzania - Zambia railway which cost over US\$450 million. China has also constructed roads, wells and telecommunication facilities in Africa, with political allies being granted large projects to mark their independence such as airports, stadiums, palaces, government buildings and factories. China's support for Africans through the construction of buildings or infrastructure, by giving medical assistance or through the development of human resources is a strategy aimed at creating a long-term relationship based on mutual respect, understanding and friendship.¹³

¹¹ China Winning Resources and Loyalties of Africa', www.yaleglobal.yale.edu/article.print?id=7051 (24 March 2006)

¹² Thompson, D. (2005) 'China's Soft Power in Africa: From the Beijing Consensus to Health Diplomacy', www.asiamedia.ucla.edu/article.asp (24 March 2006)

¹³ Ibid

China's influence and sound relationship in Africa are the result of many years of investment in building relations through aid, trade, cultural and technical exchange – not just the by-product of China's recently booming economy and soaring demand for African raw materials.¹⁴

China's aid to Africa was never unconditional. Over the years, Beijing restructured its aid policy and imposed more restrictions. Interest-free government loans became discount loans offered through Chinese banks and aid grants were replaced by joint ventures and other forms of cooperation. By the late 1990s, China had established 480 joint ventures in 47 countries in Africa.¹⁵

A trade relationship between Africa and China is demonstrated in investment by Chinese companies in Africa. By 2004, nearly 700 Chinese companies were operating in 49 African countries. Chinese state companies invest mainly in oil, mines, fishing, woods, precious metals and infrastructure and also in sectors that the West has neglected because they are less profitable. For example, China has reopened the Zambian copper mines and is looking for oil fields off the coast of Gabon. In 2004, Chinese investments in Africa accounted for more than US\$900 million. This is around 6% of total investments of US\$16 billion in Africa.¹⁶

China is investing in countries where it is getting its natural resources from. In 2004, oil-exporting countries such as Algeria, Libya, Nigeria and Sudan accounted for 54% of total Chinese investments. Zambia is also an important trade partner and China recently reopened the Chambezi Mining Company. Other countries that received a relatively large share of Chinese trade were Ethiopia and Botswana.¹⁷ According to the Chinese, Botswana has a politically stable environment and enjoys amicable relations with its neighbouring countries. Moreover, its products enjoy free access to the whole of Southern African market. All these factors are in fact positive reasons why increasing numbers of Chinese businesses and investments – ranging from construction, textiles, and services, wholesale and retail industries – are coming to Botswana.¹⁸

¹⁴ Ibid

¹⁵ Shelton, G. (2001) 'China and Africa: Building an Economic Partnership', *South African Journal of International Affairs*, 8 (2): Winter.

¹⁶ Marks, S. (2006) 'China in Africa – the New Imperialism?'

¹⁷ Source: China Statistical Yearbook 2005, National Bureau of Statistics of China.

¹⁸ <http://bw.china-embassy.org/eng/dszc/Info/P020050928144852194783.pdf>

Not all Chinese investment in Africa is viewed positively by the international community. First, Chinese (construction) firms have lower costs and can consequently outbid their western competitors, winning contracts for projects. International observers fear that the Chinese way of doing business – paying bribes and attaching no conditions – undermines local efforts to increase transparency and good governance. And the IMF and the World Bank are unable to then put as much pressure on countries because they are supported by China. Finally, Chinese companies are bringing their own labourers to work in Africa. In areas where unemployment is already high, the effects of migrant Chinese labour will be felt over time. For example in Angola, some domestic suppliers and retailers have had to close down because they could not compete with the Chinese.¹⁹

1.2 Statement of the Research Problem

Against the backdrop of its three decades of phenomenal economic growth, the economic policies of the People's Republic of China (henceforth, China) have attracted growing interest from academics and policymakers.²⁰ There is an abundance of studies on China's economic growth, its international trade, its ability to attract foreign direct investment (FDI), and its skyrocketing international reserves. Further, issues that are associated with China's on-going process of opening up its economy and its increasing role in the global economy arena are intensively scrutinized. These, for example, include the global payments imbalances and the valuation of the Chinese currency. It is perceived that China's overseas investment activity has reached a level that could challenge international investment norms and affect international relations.²¹ Indeed, the 2010 United Nations survey reported that China is ranked as the second most promising global investor.²²

China's recent investment in Africa is generally perceived to follow the state-driven strategy of providing infrastructure and in return acquiring natural resources from African

¹⁹ Marks, S. (2006) 'China in Africa – the New Imperialism?'

²⁰ Aizenman, Joshua, and Jaewoo Lee, 2010, "Real Exchange Rate, Mercantilism and the Learning by Doing Externality," *Pacific Economic Review*, 15, 324-335.

²¹ Rosen, Daniel H. and Thilo Hanemann, 2009, "China's Changing Outbound Foreign Direct Investment Profile: Drivers and Policy Implications," Policy Brief 9-14, Peterson Institute for International Economics.

²² UNCTAD, 2010 a, *World Investment Prospects Survey 2010–2012*. New York and Geneva: United Nations.

nations. Foster *et al.*, for example, list some Chinese-financed infrastructure projects in Africa that are paid for by natural resources between 2001 and 2007.²³ The link between infrastructure assistance and resources rich countries is that it is often the most resources rich states that are in dire need of infrastructure development and support.²⁴ In Kenyan case, the major exports to China are hides and skins, sisal, fiber, coffee, tea, fishery products, horticultural products and scrap metals.²⁵

In Kenya, China has invested in construction of major road networks such as Thika Highway which connect Nairobi, Thika and northern part of the country. It has long been recognized that an adequate supply of infrastructure services is an essential ingredient for productivity and growth.²⁶ For example, there is persuasive evidence that adequate infrastructure provision is a key element in the “behind the border” agenda required for trade liberalization to achieve its intended objective of efficient resource reallocation and export growth. Also, a number of studies have argued that generalized access to infrastructure services plays a key role in helping reduce income inequality.²⁷ Empirical studies have assessed the contribution of infrastructure to the level and growth of aggregate output therefore, it is important for a country to evaluate the economic input of foreign investment in infrastructure development.

Previous studies done in Kenya in relation to international business have not focused on the impact of international economic relations between Kenya and other nations on development of Kenyan economy. Past studies in Kenya in relation to international business have focused on areas such as assessment of the perceived attraction of the Kenyan market to international airlines,²⁸ state of local advertising agencies in Kenya

²³ Foster, Vivien, William Butterfield, Chuan Chen, Nataliya Pushak, 2008, *Building Bridges: China's Growing Role as Infrastructure Financier for Sub-Saharan Africa*, Washington DC, World Bank.

²⁴ Corkin, Lucy, Christopher Burke and Martyn Davies, 2008, “China's Role in the Development of Africa's Infrastructure,” SAIS Working Papers in African Studies no. 04-08, The Johns Hopkins University

²⁵ Onjala, J. (2008). *A Scoping Study on China- Africa Economic Relations: The Case of Kenya Revised Final Report submitted to African Economic Research Consortium (AERC)*, Nairobi 5th March, 2008

²⁶ World Bank, 1994. *World Development Report*: Washington, DC, The World Bank.

²⁷ Lederman, D., Maloney, W., Serven, L., 2004. *Lessons from NAFTA*. Unpublished manuscript

²⁸ Mutia B.N. (2002). *An assessment of the perceived attraction of the Kenyan market to international airlines*.

before and after affiliation with international advertising agencies.²⁹ e-business as a mode of international business engagement,³⁰ analysis of factors affecting the provision of services by banks to international business,³¹ challenges faced by African airlines in selecting and entering international markets,³² factors that make regional integration attractive to international capital inflows,³³ effects of money laundering on international business³⁴ and a survey of the hedging strategies used in managing transaction risk exposure in international trade.³⁵ Moreover, there has been a study on influence of culture on strategic human resource management practices in Multinational Companies (MNC) in Kenya,³⁶ the benefits of foreign direct investment in the presence of price distortion³⁷ and a survey of foreign direct investment in summit level group of developing countries including Kenya³⁸. Therefore, this study sought to determine the impact of international economic relations between Kenya and China on Kenyan economy through a case study of construction of Thika highway by Chinese companies as a lead to improvement of the transport sector in the country.

²⁹ Radier, B. (2003). Local advertising agencies in kenya before and after affiliation with international advertising agencies

³⁰ Odiko, V (2004). E-business as a mode of international business engagement. The case of Kenya national handloom weavers association

³¹ Kisia B.A. (2006). Analysis of factors affecting the provision of services by banks to international business. The case of national bank of Kenya

³² Makori, V. O. (2006). Challenges faced by african airlines in selecting & entering international markets

³³ Korir, P. (2007). Factors that make regional integration attractive to international capital inflows: A case study of the EACU

³⁴ Mutheu, M. M. (2008). Perceived effects of money laundering on international business: A case study of banks in Kenya

³⁵ Muthinja, M. M. (2008). A survey of the hedging strategies used in managing transaction risk exposure in international trade.

³⁶ k'obonyo, P., & Dimba, B (2007). Influence of Culture on Strategic Human Resource Management (SHRM) Practices in Multinational Companies (MNC) in Kenya: A Critical Literature Review, College of Humanities and Social Sciences, University of Nairobi, Kenya.

³⁷ Wasow, B. (2003). The Benefits of Foreign Direct Investment in The Presence of Price Distortion: The Case of Kenya, Photocopy (May).

³⁸ Summit Level Group of Developing Countries (2010). A Survey of Foreign Direct Investment in Group of Fifteen Countries, Working Paper Series, Volume 7, 3-11.

1.3 Objectives of the Study

The overall objective of this study is to determine the impact of international economic relations between Kenya and China on Kenyan economy through a case study of construction of Thika highway by Chinese companies.

The study was guided by the following specific objectives:

- i. To determine the impact of Chinese foreign investment policies on the Kenyan economy.
- ii. To establish different strategies used by government ministries in Kenya to strengthen international economic relations.
- iii. To establish the economic benefits associated with the construction of Thika highway by Chinese companies.

1.4 Literature Review

1.4.1 Foreign direct investment (FDI)

FDI occurs when there is a transfer of tangible or intangible assets from a natural person or a company whose majority of shares are directly or indirectly held by natural persons of foreign nationality, into a host country with the specific purpose of use in that country to generate wealth under the total or partial control of the owner of the assets.³⁹

FDI is the act of purchasing an asset and at the same time acquiring control of it. Control by the latter is understood as the acquisition of a significant degree of influence over the decision making of the direct investment entity. The concept of control as a determinant of FDI can be found in the definitions found in the frameworks of the International Monetary Fund (IMF) and the Organization of Economic Cooperation for Development (OECD).⁴⁰ Their definitions are the most commonly used guidelines. The IMF defines the concept in its Balance of payments Manual as; “Direct investment is the category of

³⁹ Sornarajah, M, (2004). The International Law on foreign Investment, Cambridge University Press, Cambridge, pp 4.

⁴⁰ Organisation for Economic Co-Operation and Development, OECD (1996), Detailed Benchmark Definition of Foreign Direct Investment, 3(1), 7-10.

international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in an enterprise resident in another economy.⁴¹

The lasting interest implies the existence of a long term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise. Direct investment comprises not only the initial transactions establishing the relationship between the investor and the enterprise but also all subsequent transactions between them and among affiliated enterprises; both incorporated and unincorporated.⁴²

The OECD, in the guidelines contained in its detailed benchmark definition of Foreign Direct Investment, applies a definition with a slightly different formulation though with exactly the same components: a lasting interest by a resident entity in one economy in an entity located in a host economy, which is considered to exist when two interdependent and interrelated situations are present: the existence of a long-term relationship between the direct investor and the local entity and a significant degree of influence on the management of the local entity. The entity in the home country can be referred to as the direct investor and the one in the host country as the direct investment entity.⁴³

The characteristics in the definition of FDI by IMF and OECD are present in the definition used by the United Nations Statistics Division which defines FDI as investments made to acquire a lasting management interest in an enterprise operating in a country other than that of the investor, the investor's purpose being an effective voice in the management of the enterprise.⁴⁴ OECD highlights in its guideline that absolute control by the foreign direct investor is not required and that it should be considered enough that the investor's transaction enables him to participate in or influence, the management of the direct investment entity, and considers those conditions evidenced by an ownership of at least 10 percent.

⁴¹ International Monetary Fund, IMF (1993). Balance of payment Manual, Fifth edition, Washington D.C., page 86.

⁴² International Monetary Fund, IMF (1993). Balance of payment Manual, Fifth edition, Washington D.C., page 86.

⁴³ Organisation for Economic Co-Operation and Development, OECD (1996), Detailed Benchmark Definition of Foreign Direct Investment, 3(1), 7-10.

⁴⁴ UN STATISTICS (http://unstats.un.org/unsd/cdb/cdb_dict_xrxx.asp?def_code=400).

OECD guidelines recommend States to define FDI in their respective legal and regulatory frameworks by retaining a threshold of 10 percent i.e., that the ownership by direct investor of such percentage of the ordinary shares or voting power of an incorporated direct investment entity or the equivalent if it is an unincorporated entity, be considered as determinative of direct investment relationship. The same recommendation is contained in the Balance of Payment Manual of IMF. The rationale for this is that the presence of such percentage of ownership evidences the ability of direct investor to influence the management of the enterprise, and although recognizing that in some cases a lower percentage of ownership of the ordinary shares or voting stock may give the direct investor substantial decision-making influence while in other circumstances a higher percentage is not accompanied by any significant influence, the IMF and OECD stress that they do not recommend the states to apply the 10 percent threshold in a flexible manner as to fit to the circumstances. They recommend that any ownership or decision making power of less than 10 percent should not be considered as FDI even if the foreign direct investor has an effective voice in the management, and that a higher percentage lead to FDI qualification even if the decision-making influence of the investor is not significant or even nonexistent.⁴⁵

1.4.2 Forms of foreign direct investment

FDI can take various forms. A distinction can be made between Greenfield investments, mergers and acquisitions (M&A), reinvestment of earnings and other kinds of direct investment capital inflows.⁴⁶ However, the main forms that FDI takes are Greenfield investments and international mergers and acquisitions (M & A).

Green field FDI: The category of Greenfield FDI refers to an investment in new assets; *i.e.*, the creation of an entirely new business entity. The construction of a factory in the host country would for example be qualified as a Greenfield investment. Greenfield *FDI* can be opposed to an investment in an already existing business entity which only results

⁴⁵ Organisation for Economic Co-Operation and Development, OECD (1996), Detailed Benchmark Definition of Foreign Direct Investment.

⁴⁶ Jean-Yves Ph. L. Steyt 2006. Comparative Foreign Direct Investment Law. Determinants of the Legal Framework and the Level of openness and attractiveness of host economies. Page 28.

in a change of the ownership of that entity; *i.e.*, a merger or other kind of acquisition. Greenfield investments constitute the major part of FDI transactions in developing countries.

Mergers and Acquisition: M&A in FDI can be defined as an investment by which a foreign investor acquires existing assets in the host economy.⁴⁷ The concept of outbound M&A is used when the operation involves a national buyer and a non-local target, whereas inbound M&A refers to the reverse situation. This form of FDI is predominant in developed countries.

1.4.3 Foreign direct investment in East Africa

East Africa is a region overflowing with potential for foreign investments. From agriculture to minerals to tourism to energy, investment opportunities abound. With the aim of harnessing this potential to cause economic growth and development in the region, the five Partner States of the East African Community (Uganda, Kenya, Tanzania, Rwanda and Burundi) have agreed to cooperate in the areas of Investment and Industrial Development. The cooperation has been further enhanced by the coming into force of the East Africa Community Protocol on the establishment of East Africa common market.⁴⁸ The co-operation seeks to, among others, rationalize investments as well as harmonize investment incentives with a view to promoting the Community as a single investment area.

The doctrine of state sovereignty which is a basic principle of international law in the context of foreign investment means that a state can decide at its discretion how to regulate foreign investment and how to treat foreign investors. Consequently, the partner states of East Africa can freely decide whether to establish a liberal and hospitable FDI climate or not. They can prohibit the entry of foreign investment; establish barriers, conditions, restrictions or limits on FDI inflows. Sornarajah stresses that the power of

⁴⁷ C CALDERON, Cesar; LOAYZA, Norman and SERVEN, Luis, Greenfield Foreign Direct Investment and Mergers and Acquisitions: Feedback and Macroeconomic Effects, Policy Research Working Paper, World bank, no. WPS 3192, 2 (<http://www-wds.worldbank.org>).

⁴⁸ Article 29 of the Protocol provides for the protection of cross border investments within the common market

exclusion implies the power to admit conditionally. States can freely decide whether their system should discriminate foreign investors compared to their local counter parts, or whether foreign investors from certain countries should be treated differently than those of others.

Thus all the partner States have their own foreign direct investment laws despite the existence of legal frameworks in this area within EAC. Their FDI laws are in most instances similar and in some cases; the States have adopted the same International Instrument on settlement of investment disputes. The pertinent elements in the laws can broadly be regrouped into four categories of provisions: the rule that apply to the entry of FDI, those applying to the treatment and protection of foreign Settlement of investment disputes. On the basis of these four categories of rules common to all foreign investment legislation of the East African countries, the following broad areas will be discussed: the types of entry procedures that can be encountered, the exclusion of certain sectors of East African economy from FDI and the underlying rationales for such carve-outs, Foreign ownership restrictions; entry conditions and performance requirements, employment of locals, minimum capital, local content and export quotas; the treatment of foreign investors; legal protection and guarantees including the issue of expropriation; financial and other incentives to attract foreign direct investors; the regime applicable to the settlement of disputes between foreign direct investors and the host States.

It would have been less complex to extract the legal provisions regulating FDI in the different five East African States from FDI law in a series of organized and comprehensive investment laws and regulations and even more so if the rules are integrated in a single comprehensive investment code than when a country's FDI regime is dispersed over a broad set of sources. In any event, an increasing number of East African States are opting for more transparency of their regulatory FDI framework; consequently, the number of national systems with a well organized and easily accessible FDI regime has been increasing over the years. Case in point is Uganda and Burundi through their commercial law reform with emphasis on investment laws.

The national provisions governing the entry and establishment of foreign direct investments are essential characteristics of a host country's investment system. As noted earlier on, the application of the doctrine of state sovereignty to the issue of FDI means

that a State can decide at its discretion to exclude or restrict foreign investment and consequently also to admit conditionally. At the occasion of the entry of FDI, the foreign investor has to opt for a particular business structure.

The FDI entry procedures can be broadly divided in two categories; notification and approval procedures. The concept of an FDI notification system is used as meaning that the foreign direct investor has the obligation to declare the investment transaction to the administrative authority designated by the national law for those purposes. The following are the administrative authorities for foreign direct investment in East Africa: Uganda Investment Authority,⁴⁹ Kenya Investment Authority,⁵⁰ Tanzania Investment Centre,⁵¹ Rwanda Investment Promotion Agency,⁵² Zanzibar Investment Promotion Agency⁵³ and National Investment Commission in Burundi.⁵⁴

On the other hand, in an approval and screening system, the foreign investor cannot proceed with his projected FDI transaction before having obtained administrative approval. The evidence of compliance with the different entry and foreign investment requirement is the license, Certificate of Registration and Investment Certificate issued by the administrative authorities of the different partner States.⁵⁵

The East Africa Community Model Investment Code 2006 seem to encourage the variation in the minimum capital requirement as it provides in section 8 that the responsible ministers in the partner states can determine the minimum capital to be invested by the foreign investor in any of its partner states. The reason for this may be attributed to the differing level of economic development within East Africa. Notwithstanding the principle of state sovereignty, and coming into force of the common market which may go a long way to introduce a uniform currency, East African Community should consider coming up with a uniform minimum capital requirement for foreign investments or ban the minimum capital requirement.

⁴⁹ Section 2 of The Investment Code Act Cap 92

⁵⁰ Section 14 of The Investment Promotion Act , 2004

⁵¹ Section 4 of The Tanzania Investment Act 1997

⁵² Investment Code Article 2 of Law No 14/98 of 18/12/1998 Establishing the Rwanda Investment Promotion Agency³

⁵³ <http://www.zanzibarinvest.za>

⁵⁴ The Investment Code Law No.1 /005 of Burundi

⁵⁵ Issued by Kenya Investment Authority under section 4 of The Investment Promotion Act, 2004

1.4.4 Treatment of Foreign Investors

National Treatment is the commitment by a country to treat foreign investors and investments no less favourably than domestic investors and investments. It is a core principle through which Free Trade Agreement (FTA) parties seek to liberalize investment flows. The granting of national treatment to investors in the pre-establishment phase is important because it determines the level of liberalization. In the OECD Draft Multilateral Agreement on Investment of April 24 1998,⁵⁶ it has been stated that the host country has an obligation to treat foreign investors and their investments in the same manner the country treats its own investors with respect to the establishment, acquisition, expansion, operation, management, maintenance, use, enjoyment and sale or other disposition of investments.

The OECD Draft Multilateral Agreement on Investment of April 24 emphasizes the principle of Most Favoured Nation (MFN) treatment which obliged the host nation to accord equal treatment to foreign investors from different countries.⁵⁷ According to United Nations Conference on Trade and Development (UNCTAD),⁵⁸ most favoured nation treatment is a commitment to treat a foreign investor or investment from one jurisdiction no less favourably than an investor or investment from any other jurisdiction that has been awarded MFN status. In a bilateral free trade agreement, the value of the MFN principle lies in the ability for an FTA partner to benefit from more liberal treatment in third party agreements. It also has a broader value where it applies a standard to create a liberalizing dynamic.⁵⁹ This will depend on whether the extension of MFN treatment is limited or excluded. Many FTAs, therefore, allow a party to withhold its most liberalizing treatment from other parties. MFN treatment has been defined as the cornerstone of the World Trade Organization (WTO) and the defining principle of the General Agreement on Tariffs and Trade (GATT).⁶⁰

⁵⁶ <http://www.oecd.org/dataoecd/46/40/1895712.pdf>

⁵⁷ Article 3 of the draft of 28 April 1998, of negotiations text of the OECD Multilateral Investment Agreement

⁵⁸ UNCTAD (2008) Recent Developments in International Investment Agreements (2007 – June 2008), IIA Monitor No.2 (2008) International Investment Agreements, pp 296

⁵⁹ Ibid

⁶⁰ WTO (2004). Consultative Board. The Future of the WTO: Addressing Institutional Challenges in the New Millennium (Geneva: WTO).

The World Trade Organization (WTO) agreements stipulate that any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties. According to WTO, equal treatments are granted in respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and in respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation.⁶¹

The Model Investment Code⁶² is in line with this principle on treatment of foreign investors and their investments particularly within the East Africa community. The Protocol on the establishment of the East Africa common market has its purpose in the realization and promotion of economic growth within the community.⁶³ It provides for among other things; national treatment, protection of cross border investments and coordination of trade relations. Every country in East Africa reserves national treatment for foreign investors, implements a certain number of sector-specific FDI restrictions in the sense that local investors are favoured over foreign investors. For example in Kenya, a foreign investor is required to invest Five Hundred thousand dollars to be issued with investment certificate as opposed to local investors who are required to invest five million Kenya shillings only.⁶⁴

Foreign Investment legislations often include a provision guaranteeing compensation in case of expropriation of the investment property. Such provisions have a 'signaling function' and are especially important in countries with a substantial expropriations history.⁶⁵ It is recommended by the World Bank Guidelines on the Treatment of Foreign Direct Investment that States only expropriate in pursuance of a public purpose and without discrimination between nationals and foreign investors. The World Bank guidelines also stress the importance of an adequate, effective and appropriate

⁶¹ WTO Report of the Appellate Body, EC – Tariff preferences, 7 April 2004, para. 104;

⁶² East Africa Community Model Investment Code July 2006

⁶³ Articles 3 and 4 of the Protocol.

⁶⁴ Section 4 (1) of the Investment Promotion Act, 2004.

⁶⁵ Sornarajah, M, (2004). *The International Law on foreign Investment*, Cambridge University Press, Cambridge,

compensation in case of expropriation.⁶⁶ Since in Kenya, the law is silent on acquisition and compensation of foreign investment property, it leaves the investors with a lot of uncertainties which makes its foreign investment climate unattractive and below the generally accepted standards. Kenya should recognize the loopholes and embark on reforming its foreign investment laws.

1.4.5 Fiscal Incentives and Attraction of Foreign Investments

Incentives in the broad context of foreign investment include all governmental measures or actions from which direct investors benefit or could benefit. Defined narrowly, it refers to measures which are directly in relation with the foreign investment and that impact directly on the fact cost of a project or on the returns from the sale of a project's product.⁶⁷ The narrow definition, contrary to the broader one, does not include measures to improve the host country's infrastructure, the relaxing of environmental or labor standards, or investment promotion activities, but rather measures such as subsidies, tax holidays or incentives, exemption of import duties for equipment or raw material, and many others.⁶⁸

Providing incentives is a frequently used strategy to attract foreign direct investors. Host countries are interested in FDI that is most productive for its national economy; incentives are often available to selected category of foreign direct investors.

International law recognizes the sovereign right of each state to tax aliens resident or owning property within its territory.⁶⁹ However, the establishment of unfair tax discrimination against foreign nationals and their property is regarded in international practice as an unfriendly act which may give rise to protest or retaliation by restoration.

The Investment Promotion Act of Kenya does not provide for direct fiscal incentives as a way of attracting investments. Part 111 of the Act provides for investment certificate benefits which only relate to work permits after payment of requisite fees. The Act however provides in section 15 (2) (a) (iii) that the Investment Authority shall in

⁶⁶ Article 4 of the World Bank Guide Lines on the Treatment of Foreign Direct Investment.

⁶⁷ Seid, S. H. (2002). Global Regulation of Foreign Direct Investment, Ashgate, Alderhot, page 40.

⁶⁸ Seid, S. H. (2002). Global Regulation of Foreign Direct Investment, Ashgate, Alderhot, page 40.

⁶⁹ Nwogugu, E. I. (1965). The Legal Problems of Foreign Investment in Developing Countries, Manchester University Press, pp. 9-10.

promoting and facilitating investment assist foreign and local investors in obtaining incentives or exemptions under the Income Tax Act, the customs and Excise Act, the Value Added Tax Act or other legislation. The Act does not clearly spell out the incentives that a foreign investor is entitled to.

1.4.6 The Effects of Infrastructure Development on Growth and Income Distribution

It has long been recognized that an adequate supply of infrastructure services is an essential ingredient for productivity and growth.⁷⁰ In recent years, however, the role of infrastructure has received increased attention. From the academic perspective, a rapidly growing literature has sought to quantify the contribution of infrastructure to income and growth.⁷¹ Infrastructure is a widely discussed theme in a variety of areas of the policy debate. For example, there is persuasive evidence that adequate infrastructure provision is a key element in the international agenda for trade liberalization aimed at achieving efficient resource reallocation and export growth. Besides, a number of studies have argued that generalized access to infrastructure services plays a key role in helping reduce income inequality.⁷² Against this background, there is a growing perception that in many countries, the pressures of fiscal consolidation have led to a compression of public infrastructure spending, which has not been counterbalanced by the increase in private sector participation, thus resulting in an insufficient provision of infrastructure services with potentially major adverse effects on growth and inequality.^{73,74}

Empirical studies have assessed the contribution of infrastructure to the level and growth of aggregate output.^{75,76} There has been a rapidly expanding literature on the distributive

⁷⁰ World Bank, 1994. *World Development Report*: Washington, DC, The World Bank.

⁷¹ Gramlich, E., 1994. "Infrastructure Investment: A Review Essay." *Journal of Economic Literature* 32, 1176–96.

⁷² Lederman, D., Maloney, W., Servén, L., 2004. *Lessons from NAFTA*. Unpublished manuscript

⁷³ Blanchard, O. and F. Giavazzi, 2003. *Improving the SGP through proper accounting of public investment*. Unpublished manuscript.

⁷⁴ Easterly, W., Servén, L., 2003. *The Limits of Stabilization: Infrastructure, Public Deficits, and Growth in Latin America*. Stanford University Press and the World Bank.

⁷⁵ Demetriades, P. and Mamuneas, T., 2000. "Intertemporal Output and Employment Effects of Public Infrastructure Capital: Evidence from 12 OECD Economies." *The Economic Journal* 110, 687–712.

impact of infrastructure provision and reform, which arose largely as a result of the worldwide trend toward increased private sector participation in infrastructure.^{77,78}

There is a positive and significant output contribution of three types of infrastructure assets – telecommunications, transport and power. The estimated marginal productivity of these assets significantly exceeds that of non-infrastructure capital.⁷⁹ The impacts of infrastructure on long-term growth are much less abundant. Public expenditure on transport and communications significantly raises growth and measures of physical infrastructure are positively and significantly related to growth in GDP per capita.⁸⁰

Aside from the effects of infrastructure development on aggregate income growth, another strand of recent literature has examined its effects on income inequality. The underlying idea is that, under appropriate conditions, infrastructure development can have a positive impact on the income and welfare of the poor over and above its impact on average income.⁸¹

1.5 Conceptual framework

Conceptual Framework is defined as the result of when a researcher conceptualizes the relation between variables in the study and show the relationship graphically or diagrammatically.⁸² A conceptual definition therefore is an element of the scientific research process, in which a specific concept is defined as a measurable occurrence or in measurable terms; it basically gives one the meaning of the concept.⁸³ Independent

⁷⁶ Esfahani, Hadi, and Maria Teresa Ramirez. 2002. "Institutions, Infrastructure and Economic Growth." *Journal of Development Economics* 70, 443–77.

⁷⁷ Estache, A., Foster, V. and Wodon, Q., 2002. "Accounting for Poverty in Infrastructure Reform: Learning from Latin America's Experience." WBI Development Studies, Washington, DC: The World Bank.

⁷⁸ Calderón, C. and Chong, A., 2004. "Volume and Quality of Infrastructure and the Distribution of Income: An Empirical Investigation." *Review of Income and Wealth* 50, 87-105.

⁷⁹ Calderón, C. and Servén, L., 2003a. "The Output Cost of Latin America's Infrastructure Gap." In: Easterly, W., Servén, L., eds., *The Limits of Stabilization: Infrastructure, Public Deficits, and Growth in Latin America*. Stanford University Press and the World Bank, pp. 95-118.

⁸⁰ Sanchez-Robles, B., 1998. "Infrastructure Investment and Growth: Some Empirical Evidence." *Contemporary Economic Policy* 16, 98-108.

⁸¹ López, H., 2004. "Macroeconomics and Inequality." *The World Bank Research Workshop, Macroeconomic Challenges in Low Income Countries*, October

⁸² Mugenda, O.M., & Mugenda, A.G. (1999). *Research Methods, Quantitative and Qualitative Analysis*-African Center for Technology Studies. Nairobi: Applied Research and Training Services (ACTS)

⁸³ Mugenda, A.G. (2008). *Social Science Research: Theory and Principles*. Nairobi: Arts Press.

variables are those variables which are systematically varied by the researcher. On the other hand, dependent variables are those variables whose values are presumed to depend on the effects of the independent variables.⁸⁴

The independent variables for the study are foreign investment policies, bilateral trade agreements, investment opportunities and political stability while the dependent variable is economic development. The relationship between these variables is presented graphically in the conceptual framework shown in figure 1.0.

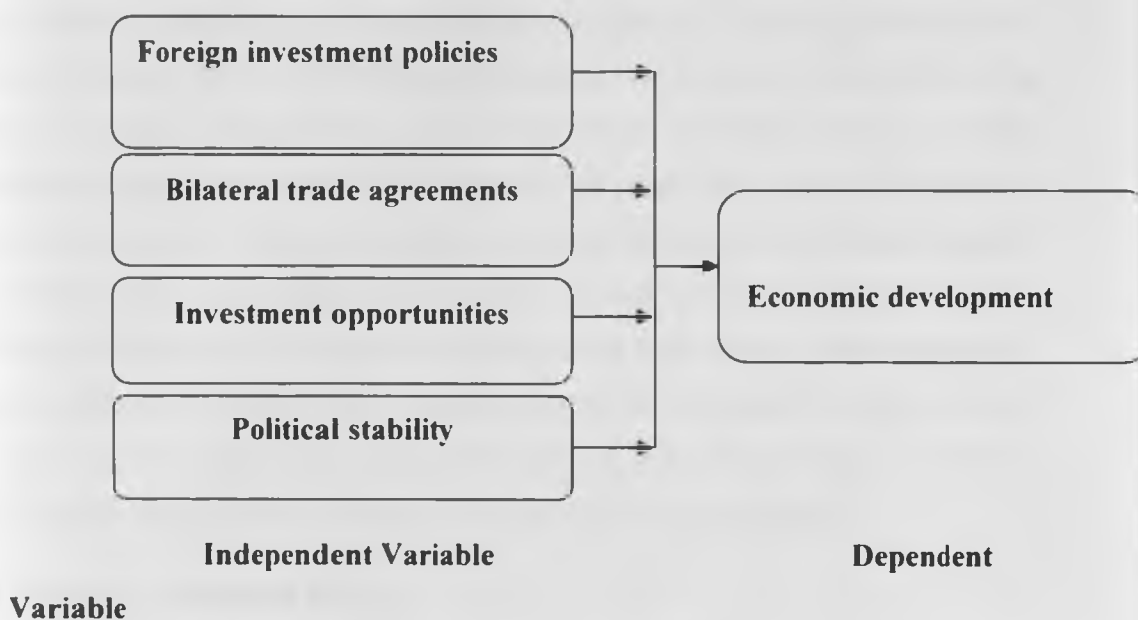


Figure 1:0: Conceptual Framework.

1.6 Theoretical Literature review

1.6.1 International trade theories

International trade issues generally pose three issues for economists and international relations scholars. The first is the explanations of trade flows between at least two

⁸⁴ Mugenda, A.G. (2008). Social Science Research: Theory and Principles. Nairobi: Arts Press.

nations. The second refers to the nature and extent of gains or losses to an economy. Finally, the third issue concerns the effects of trade policies on an economy. Most theories of international trade are dedicated to the first question, and attention will now turn to theoretical responses to such an issue in the form of: classical trade theory; factor proportion theory; and product life cycle theory.

1.6.1.1 Classical trade theory

Classical trade theory dictates that the extent to which a country exports and imports relates to its trading pattern with other nations. That is, countries are able to gain if each devotes resources to the generation of goods and services in which they have an economic advantage.⁸⁵ Therefore, classical trade theory effectively describes the scenario where a country generates goods and services in which it has an advantage, for consumption indigenously, and subsequently exports the surplus. Consequently, it is sensible for countries to import those goods and services in which they have an economic disadvantage. Economic advantages/disadvantages may arise from country differences in factors such as resource endowments, labour, capital, technology or entrepreneurship. Thus, classical trade theory contends that the basis for international trade can be sourced to differences in production characteristics and resource endowments which are founded on domestic differences in natural and acquired economic advantages. However, over and above such a general insight into international trade, classical trade theory is unable to offer any explanation as to what causes differences in relative advantages.

1.6.1.2 The factor proportion theory

The factor proportion theory, in contrast to classical trade theory, is able to provide an explanation for the differences in advantage exhibited by trading countries. According to this theory, countries will tend to generate and export goods and services that harness large amounts of abundant production factors that they possess, while they will import goods and services that require large amounts of production factors which may be

⁸⁵ Ricardo, D. (1817), "Principles of political economy", in Saffra, P. (Eds), *The Works and Correspondence of David Ricardo*, Vol. 1

relatively scarce.⁸⁶ Therefore, this theory extends the concept of economic advantage by considering the endowment and costs of factors of production.

1.6.1.3 Product life cycle theory

Classical trade theory and the factor proportion theory have been shown to be deficient in explaining more recent patterns of international trade. For example, the 1960s witnessed significant technological progress and the rise of the multinational enterprise, which resulted in a call for new theories of international trade to reflect changing commercial realities (Leontief, 1966). At that time, the product life cycle theory of international trade was found to be a useful framework for explaining and predicting international trade patterns as well as multinational enterprise expansion. This theory suggested that a trade cycle emerges where a product is produced by a parent firm, then by its foreign subsidiaries and finally anywhere in the world where costs are at their lowest possible (Vernon, 1966, 1971; Wells, 1968, 1969). Furthermore, it explains how a product may emerge as a country's export and work through the life cycle to ultimately become an import. The essence of the international product life cycle is that technological innovation and market expansion are critical issues in explaining patterns of international trade. That is, technology is a key factor in creating and developing new products, while market size and structure are influential in determining the extent and type of international trade.

While these theories are insightful, a number of modern international trade theories have emerged recently which take account of other important considerations such as government involvement and regulation. However, it remains that these theories make several assumptions which detract from their potential significance and contribution to international business. For instance, they assume that: factors of production are immobile between countries; perfect information for international trade opportunities exists; and,

⁸⁶ Hecksher, E., Ohlin, B. (1933), *Interregional and International Trade*, Harvard University Press, Cambridge, MA.

traditional importing and exporting are the only mechanisms for transferring goods and services across national boundaries.⁸⁷

1.6.2 Foreign direct investment theories

Certain theorists have attempted to address limitations of international trade theories under the rubric of FDI. Foreign direct investment theories include market imperfections theory and international production theory.

1.6.2.1 The market imperfections theory.

The market imperfections theory states that firms constantly seek market opportunities and their decision to invest overseas is explained as a strategy to capitalize on certain capabilities not shared by competitors in foreign countries. The capabilities or advantages of firms are explained by market imperfections for products and factors of production. That is, the theory of perfect competition dictates that firms produce homogeneous products and enjoy the same level of access to factors of production. However, the reality of imperfect competition, which is reflected in industrial organization theory,⁸⁸ determines that firms gain different types of competitive advantages and each to varying degrees. Nonetheless, market imperfections theory does not explain why foreign production is considered the most desirable means of harnessing the firm's advantage.⁸⁹

1.6.2.2 International production theory

International production theory suggests that the propensity of a firm to initiate foreign production will depend on the specific attractions of its home country compared with resource implications and advantages of locating in another country. This theory makes it

⁸⁷ Bradley, M.F. (1991), *International Marketing Strategy*, Prentice-Hall International,

⁸⁸ Porter, M.E. (1985), *Competitive Advantage: Creating and Sustaining Superior Performance*, Free Press, New York, NY.,

⁸⁹ Dunning, J.H. (1980), "Toward an eclectic theory of international production: some empirical tests", *Journal of International Business Studies*, Vol. 11 No.1, pp.9-31.

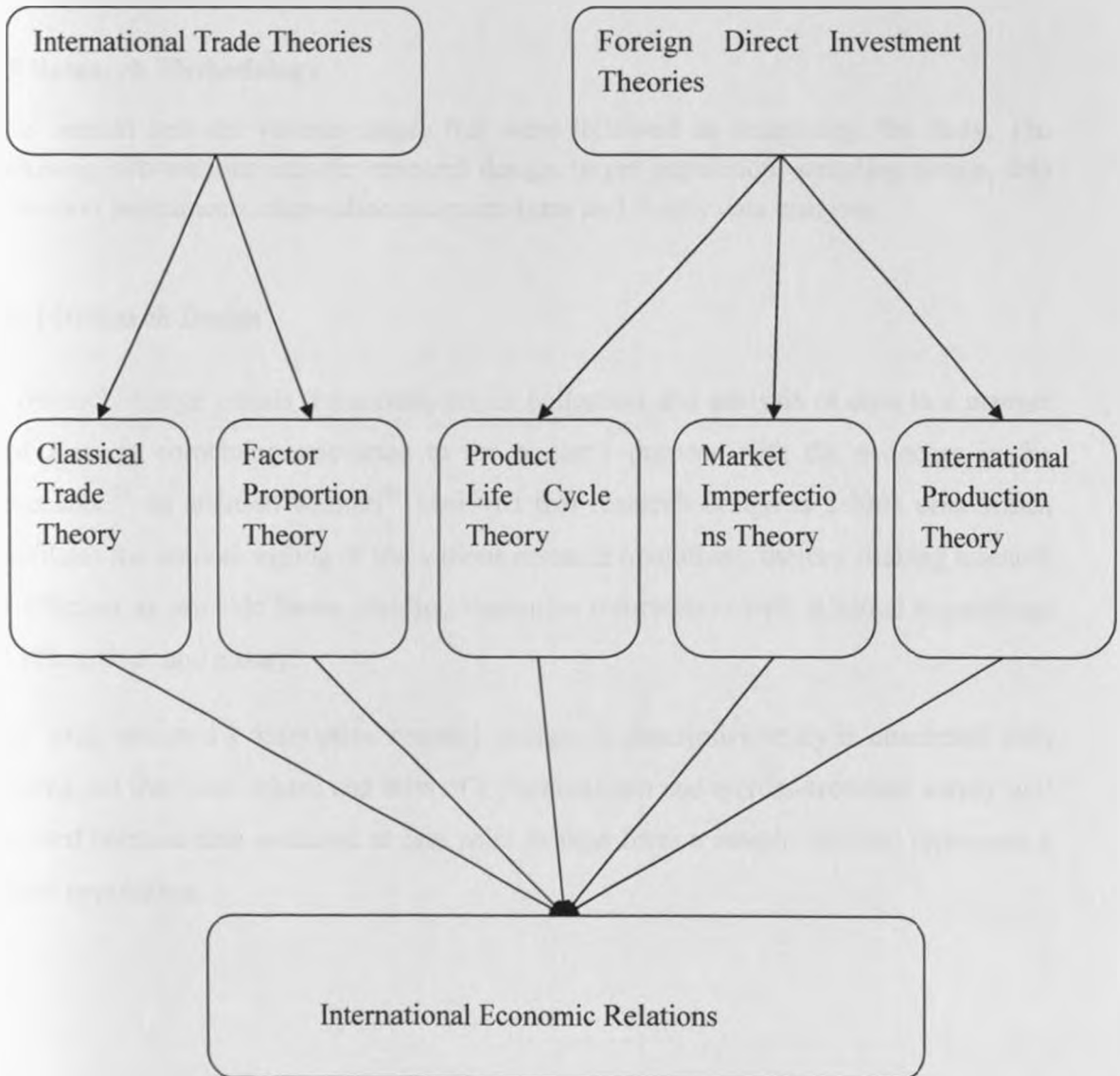
explicit that not only do resource differentials and the advantages of the firm play a part in determining overseas investment activities, but foreign government actions may significantly influence the piecemeal attractiveness and entry conditions for firms.⁹¹

⁹⁰ Buckley, P.J. (1988), "The limits of explanation: testing the internalization theory of the multinational", *Journal of International Business Studies*, Vol. 19 pp.181-93.

1.7 Theoretical framework

The theoretical framework for the study comprise of international trade theories namely, Classical Trade Theory, The factor proportion Theory and Product Life Cycle. Foreign Direct Investment theories include The Market Imperfections Theory and International Production Theory. Figure below represents theoretical framework for the study.

Figure 2: Theoretical framework



1.8 Hypotheses

The study was guided by the following null hypotheses:

- i. Chinese foreign investment policies do not favor investments in Kenya.
- ii. Chinese investments in Kenyan infrastructure have not led to increased employment.
- iii. Chinese investments in Kenyan infrastructure have no effect on gross domestic production (GDP) in Kenya.

1.9 Research Methodology

This section sets out various stages that were followed in completing the study. The following sub-sections include; research design, target population, sampling design, data collection instruments, data collection procedures and finally data analysis.

1.9.1 Research Design

A research design entails the conditions for collection and analysis of data in a manner that aims at combining relevance to the research purpose with the economy in the procedure.⁹¹ In addition Kothari⁹² observed that research design is a blue print which facilitates the smooth sailing of the various research operations, thereby making research as efficient as possible hence yielding maximum information with minimal expenditure of effort, time and money.

The study adopted a descriptive research design. A descriptive study is concerned with finding out the what, where and how of a phenomenon and a cross-sectional survey will be used because data collected at one point in time from a sample selected represents a larger population.

⁹¹ Babbie, E. (2002). *Survey research methods* (2nd ed.). Belmont: Wodsworth.

⁹² Kothari, C. R. (2004). *Research methodology: Methods and techniques*. New Delhi: New Age International (P) Limited Publishers.

1.9.2 Target Population

The target population was the Ministry of Roads, Ministry of Public Works, Ministry of Trade and Ministry of Foreign affairs.

1.9.3 Sample size

A sample is a set of entities drawn from a population with the aim of estimating characteristic of the population.⁹³ The sample for the study comprised of three departmental heads in charge of strategic planning in the Ministry of Roads, Ministry of Public Works, Ministry of Trade and Ministry of Foreign affairs. In addition, data was collected from economic and commercial counselor at the Embassy of the People's Republic of China in the republic of Kenya and from the managing directors of the three Chinese companies namely, China Wu Yi (Kenya) Corporation, Sheng Li Construction Company and Sinohydro Company. The study sought to utilize the respondents since they were more versed with different strategies used by government ministries in Kenya to promote international economic relations and the economic impact of Chinese investment in Kenya's transport sector.

1.9.4 Research Instrument

The study used an interview guide to collect the primary data. An interview guide is a set of questions that the interviewer asks when carrying out an investigation.⁹⁴ It makes it possible to obtain data required to meet specific objectives of the study. The respondents were departmental heads in charge of strategic planning from the Ministry of Roads, Ministry of Public Works, Ministry of Trade and Ministry of Foreign affairs.

1.9.5 Pilot Study

The pilot study was conducted using interview guides administered to the respondents prior to the main study. Data collected during the pilot study was not used in the final

⁹³ Siegel, N. (2003). *Research methods for managers. A skill building approach* (2nd ed.). New York: Wiley Publishers.

⁹⁴ Mugenda, O. M., & Mugenda, A. G. (2003). *Research methods: Quantitative and qualitative approaches*. Nairobi: Acts Press.

data analysis. The purpose of the pilot study was to ensure validity and reliability of the questionnaires. The accuracy of data to be collected largely depended on the data collection instruments in terms of validity and reliability.⁹⁵ Validity as noted by Robinson⁹⁶ is the degree to which result obtained from the analysis of the data actually represents the phenomenon under study. Validity was ensured by having objective questions included in the questionnaire and by pre-testing the instrument to be used through a pilot study in order to identify and change any ambiguous, awkward, or offensive questions and technique as emphasized by.⁹⁷ Reliability on the other hand refers to a measure of the degree to which research instruments yield consistent results.⁹⁸ In this study, reliability was ensured by pre-testing the questionnaire or interview guide questions with a selected sample from five respondents who were not included in the final analysis.

1.9.6 Data Analysis Methods

Data collected will be purely qualitative and it will be analyzed by means of content analysis. Content analysis is used to make inferences about the antecedents of a communication, to describe and make inferences about characteristics of a communication and to make inferences about the effects of a communication.⁹⁹ It involves observation and detailed description of phenomena that comprise the object of study. This method is preferred because the information collected will be qualitative and therefore require analytical understanding. When human coders are used in content analysis, reliability translates to the amount of agreement or correspondence among two or more coders. Reliability in content analysis will be ensured by analyzing the amount of agreement or correspondence among the key informants.¹⁰⁰

⁹⁵ Mugenda, O. M., & Mugenda, A. G. (2003). *Research methods: Quantitative and qualitative approaches*. Nairobi: Acts Press.

⁹⁶ Robinson, S. (2002). *Research methodology*. Washington D.C.: National Academies Press.

⁹⁷ Cooper, D.R. & Schindler, P.S. (2003) *Business research methods*, 8th Ed., New Delhi, Tata McGraw-Hill

⁹⁸ Mugenda, O. M., & Mugenda, A. G. (2003). *Research methods: Quantitative and qualitative approaches*. Nairobi: Acts Press

⁹⁹ Holsti, O.R. (1969). *Content Analysis for the Social Sciences and Humanities*. Reading, MA: Addison-Wesley.

¹⁰⁰ Neuendorf, K. A. (2002). *The Content Analysis Guidebook* Thousand Oaks, CA: Sage Publications.

1.10 Scope of the study

There are many forms of foreign investments in Kenya by developed nations. However this study was specifically focused on the impact of international business relations on economic development in Kenya through a case study of construction of Thika Highway by Chinese contractors. Data was collected from departmental heads in charge of strategic planning from the Ministry of Roads, Ministry of Public Works, Ministry of Trade and Ministry of Foreign affairs.

CHAPTER TWO

CHINESE FOREIGN INVESTMENT POLICIES

An important part of the economic reform process in China has been the promotion of foreign direct investment (FDI) inflow. After more than twenty years of economic reform, China has become one of the most important destinations for cross border direct investment. In this chapter, China's economic policy regarding FDI and the resulting changes in FDI inflow will be discussed.

2.1 China's foreign investment policies

China has aggressively shaped a relatively complete range of laws and regulations governing foreign investment. They include the Law of the People's Republic of China upon Foreign Wholly Owned Enterprises, Law of the People's Republic of China upon Sino-Foreign Joint Ventures, Law of the People's Republic of China upon Sino-Foreign Cooperative Enterprises, and the Guiding Directory on Industries Open to Foreign Investment. China's laws and regulations on FDI also include related preferential policies and stipulations for special economic zones in the country.¹⁰¹

China encourages favourable FDI policies. Foreign invested Enterprises (FIEs) enjoy preferential treatment when compared to domestic enterprises. In fact, FIEs are entitled to markedly different treatments depending on the region and industry, and this differential treatment is outlined by policies. Furthermore, the Chinese government has stipulated different FDI performance requirements depending on these distinctions. China has designated certain parts of the country as special economic areas and each is governed by different policies. China has also enforced two policies called Develop China's West at Full Blast and Strategy of Reviving Rusty Industrial Bases to encourage FDI into its western and northeast regions. Therefore, FDI policies in China's western region entitle

¹⁰¹ China Ministry of Commerce (2001). Detailed Implementing Rule For The law of People's Republic of China on Wholly Foreign Owned Enterprises.

foreign enterprises to even more preferential treatment than in other regions of the country.¹⁰²

The Chinese government pays much attention to industrial guidance on FDI. In June 1995, China first promulgated the Provisional Regulations upon Guidance for Foreign Investment Orientations and the Guiding Directory on Industries Open to Foreign Investment. Furthermore, the different preferential treatments granted to enterprises in various industries have mainly been determined under the Guiding Directory. This Guiding Directory was revised first in December 1997 and then again in April 2002 because of China's accession to the WTO. The Guiding Directory is important because it divides FDI-involved projects into four categories: projects that were encouraged, allowed, restricted, and prohibited. These categories are then subdivided even further. For instance, 262 types of encouraged projects, 75 types of restricted projects, and 34 types of prohibited projects exist. China currently encourages FDI for the purposes of transforming traditional agriculture, developing modern agriculture, and promoting the industrialization of agriculture; producing transportation, infrastructure, energy sources, and raw materials, and other basic industries tapping into cutting-edge, technology-oriented industries such as electronic information, bioengineering, new materials, aviation and aerospace, as well as establishing local R&D centers; encouraging foreign businesses to utilize advanced and applicable techniques to transform traditional industries such as machinery, textiles, and consumption goods manufacturing industries as well as to upgrade their equipment and facilities; using raw and renewable resources comprehensively, initiating environmental protection projects, and modernizing public utilities; encouraging export-oriented FDI projects; and building up the industries in China's western region.¹⁰³

In the past, China's FDI laws included some performance requirements. However, to meet WTO membership requirements, within a year of its entry into the organization, China revised its three laws and removed the FDI requirements regarding such criteria as export proportion, local contents, balance of foreign exchanges, technology transfer, and

¹⁰² *Ibid*

¹⁰³ China Ministry of Commerce (2003). Foreign investment report 2003. www.mfocom.gov.cn.

creation of R&D centers. The remaining restriction limited ownership share on projects falling in the “restricted” category. However, in practice, the Chinese partners of some joint ventures or cooperatives privately require technology sharing or transfer from FIE foreign investors.

2.2 Export Performance Requirement Policies

China’s FDI policies are complicated. When designing such a set of policies, multiple objectives must be met, including strengthening the country’s industrial base and increasing the domestic value added, promoting linkages, generating and increasing the level of exports, balancing trade, promoting regional development, and transferring technology.¹⁰⁴ Among these criteria, promoting exports and transferring technology (technological advancement) are China’s two most important FDI objectives.

Before China became a member of the WTO, its FDI policies regarding exports could be divided into three categories: compulsory, neutral, and voluntary. Compulsory policies required that “FDI shall be able to keep a balance of exchanges, or make sure the proportion of their domestically made products in the total number of products reaches a certain benchmark, or a certain percentage of their products must be exported.” However, since such requirements are inconsistent with the WTO Agreement on Trade- Related Investment Measures (TRIMs), these compulsory provisions were eliminated.

Neutral policies tried to create fair conditions for exports to compete internationally. For example, the tariff and value added tax VAT exemptions on re-export processing imports would level the ground for China’s companies to compete in overseas markets. Voluntary policies to promote exports were encouraged. For example, an enterprise with 70 percent of export products is entitled to a 50 percent cut in corporate income tax. Thus, major exporters enjoy more favourable treatment in terms of trade, and these policies have been linked with increasing the level of export performance of enterprises.

¹⁰⁴ China Ministry of Commerce (2001). Detailed Implementing Rule For The law of People’s Republic of China on Wholly Foreign Owned Enterprises

2.3 Reasons for China's Predominantly Export-Oriented FDI

On the whole, transnational investment can be divided into two categories: In "domestic-market seeking" investment, investors seek to enter the host country's local market. In "export-oriented" or "efficiency-pursuing" investment, investors establish production bases in the host country but export most of their products to the global market. In the past, China's domestic market was small, and the country's restrictive FDI policies prohibiting FIEs from selling locally made sense. Furthermore, China was an ideal low-cost production location to manufacture goods to export. For instance, the wage levels in the United States, Japan, South Korea, and Taiwan are 47.8 times, 29.9 times, 12.9 times, and 20.6 times, respectively, to those of China.¹⁰⁵

Today, compared with developed and even developing countries, China has lower production costs, and, equally important, its domestic market has enormous potential for growth. Moreover, China implemented an import substitution strategy between 1949 and 1979. China established a relatively complete industrial base, and trained a large number of skilled workers. All of these factors make China an ideal base for production, particularly for East Asia's FIEs. In fact, in 2002, the Japan External Trade Organization (JETRO) (2003) surveyed the overseas branches of Japanese companies and found that the percentage of surveyed companies exporting more than 70 percent of their products is 61.6 percent in China overall, with a staggering 82.5 percent in southern China, compared with the average 55.9 percent for those located in all of Asia. Another 2002 survey, conducted by the Japan Bank for International Cooperation (JBIC), found that 68.9 percent of Japanese enterprises invested in China because of its cheaper labour cost, 25.2 percent considered the country an ideal production base to export products to the global market, and 26.8 percent thought it was an ideal location to export to Japan.¹⁰⁶

The constant inflow of FDI into China has actually strengthened its capacity to be a production base for manufacturing exports. A "domino effect" inevitably occurs when FIEs in the same industry compete with one another, particularly if they are concentrated

¹⁰⁵ Xiaojuan J. (2002). *Chinas FDI Economy*. Beijing: University of China Press.

¹⁰⁶ Japan External Trade Organization (JETRO, 2003). *Japanese-Affiliated Manufacturers in Asia, Survey 2002 Summary*.

in the same region. The competition boosts the development of some supporting industries, improves the general economic climate within these supporting industries, and essentially establishes an important industrial cluster. For example, China's Pearl River Delta and Yangtze River Delta regions have emerged as world-class information technology (IT) clusters.

The formation of such industrial clusters helps China absorb an ever increasing amount of FDI, which in turn attracts more foreign investment. Thus, it is unsurprising to find that a 2003 American Chamber of Commerce in China survey of its members found that 56 percent chose to invest in the country because of its ideal location as a production base for global exports and its growing domestic market.

2.4 Effectiveness of China's Export Promotion Policies

China's policies for promoting the exports of FDI have been increasingly effective. As noted earlier, before China's membership in the WTO, there were a number of restrictive policies governing FDI that diverted many potential investors to other countries, especially since the domestic market was small and largely unavailable to FIEs. Those who did invest in China despite the restrictions did so primarily for its lower production costs and to export its products.

China's processing trade policy, which exempts input imports for re-export from tariff and value-added tax (VAT), has improved the country's export value tremendously. Two kinds of processing trade exist in China: processing trade with imported materials and processing trade with materials supplied by clients (PTS). Prior to China's WTO membership, the country maintained a relatively high tariff level.¹⁰⁷

After China reformed its tax system in 1994, imports were subject to a new 17 percent VAT; and certain imports (e.g., the automobile industry) are further subject to a 10 percent excise tax. Under such a high tariff/VAT system, without any exemptions on imports, there would be an incredible decrease in Chinese exports. In order to eliminate this possibility, China implemented the exemption policy immediately after initiating its

¹⁰⁷ China Ministry of Commerce (2003). Foreign investment report 2003. www.mfocom.gov.cn.

reform and open policies. Thus, imported raw materials and spare parts used in the export processing industry are exempt from tariff and VAT from the outset and any verification will occur after the finished goods have been exported. However, if the products are not exported and are sold domestically, FIEs will be charged the relevant tariff and VAT taxes. However, China's policy, in order to encourage domestic value added of exports, allows imported raw materials and spare parts to be sold to downstream processing enterprises without levying tariffs/VAT, as long as the processed materials are eventually exported.¹⁰⁸

Thus, China's processing trade policy has played an important role in helping China attract FDI and expand its exports. Without these exemptions, most of China's early foreign investors would not have invested in the country. In fact, processing trade has always remained the principal mode of FIE exports, and it currently contributes 80 percent of the total export value by FIEs.¹⁰⁹

Policy factors have also had a significant influence on FIE domestic purchases. As domestic supporting industries have evolved and improved and VAT reimbursement has been implemented, the percentage of local content of China's exports in the processing trade has markedly increased. The most viable explanation for the difference lies in the "VAT reimbursement for exports" policy, noted earlier, that China implemented toward these two different trading modes: domestically purchased materials used in PTI may be reimbursed but not in PTS.

Essentially, companies engaged in PTI can receive a tax rebate equal to 17 percent of the value of domestically purchased materials, but PTS companies cannot. Such a cost difference is large enough to force enterprises to make a prudent decision on where to purchase materials: domestically or abroad. Although initiated to provide equal footing for domestic raw materials, the opposite effect has occurred. The difference between PTI and PTS in terms of the domestic value increment rate has indicated that the VAT reimbursement for exports policy has effectively impacted purchasing decisions of FIEs toward imported raw materials and spare parts. China's policies to promote exports have

¹⁰⁸ Zhile W. (1995). *Investment in China of World famous FIEs*. Beijing: China Economic Press.

¹⁰⁹ *ibid*

also affected FDI. For example, an FIE with an export ratio higher than 70 percent receives a 50 percent corporate income tax “discount.” In fact, in a survey I conducted in 2001, 121 enterprises, or 27 percent, with higher than 70 percent export ratios received a corporate income tax “discount.” Although not precise, the finding illustrates that China’s policies have affected FDI and export performance.¹¹⁰

¹¹⁰ Xiaojuan J. (2002). *Chinas FDI Economy*. Beijing: University of China Press.

CHAPTER THREE

REVIEW OF KENYA'S ECONOMY

3.1 Overview of Kenyan economy

Kenya has the largest economy in East Africa, but is now facing serious competition from both Uganda and Tanzania whose economies are growing in strength. Furthermore, conditions in Kenya have deteriorated significantly over the past decade because of the failure to sustain prudent macro-economic policies, the slow pace of structural reform, and the persistence of governance problems such as corruption, a deteriorating infrastructure and an inefficient parastatal sector. Investor and donor confidence has been adversely affected, there has been a rapid build-up of short-term debt, poverty has increased and social indicators deteriorated. However, since early 1998, Kenya has pursued generally cautious macroeconomic policies, and these have gone some way towards addressing weaknesses in the governance area.

In July 2010, the World Bank launched its second Kenya Economic Update, the first being published at the end of 2009. The report, 'Running on One Engine: Kenya's Uneven Economic Performance'¹¹¹ details the country's strong recovery in 2010 after the economic shocks of the previous two years, while identifying the weak link in the economy, namely exports.

According to the World Bank, Kenya entered this decade with renewed momentum for strong and sustained growth. Economic growth in Kenya, East Africa's biggest economy, is set to accelerate over the next two years as increased rainfall boosts farm output and stable power supplies help the manufacturing industry. However, failure to address the issue of declining exports may mitigate the momentum and contribute to the economy's stagnation.

¹¹¹ 2) Poverty Reduction and Economic Management Unit Africa Region, 2010. Running on One Engine: Kenya's Uneven Economic Performance [Online] World Bank Group. Available at: <http://www.capitalfm.co.ke>.

Kenya's economy has been hit by four consecutive economic shocks i.e. post-election violence, the global financial crisis, food and oil price increases, and lastly drought, causing a significant reduction in growth. Despite these economic shocks, the Kenyan economy reached a growth rate of 2.6% in 2009, exceeding average growth in sub-Saharan Africa for that year. Strong macroeconomic policies and Kenya's relatively limited integration into the global economy shielded the country from the worst effects of the global economic downturn, apart from a steep decline in private capital flows, and subdued exports and tourism receipts.¹¹²

The domestic food crisis, resulting from the severe drought and compounded by weak governance and irregularities in the Government operated maize board, contributed to growth in the agriculture sector contracting by 2.4% in 2009. The drought also caused enduring electricity shortages, which negatively affected the manufacturing sector. The poor were hit especially hard as average income dropped and the price of maize, Kenya's staple food, rose to double world market levels. Fortunately, Government's removal of maize tariffs in mid-2009 and increased maize imports saw a drop in the cost of maize, though it remained well above international prices. Favourable production in early 2010, after much welcome rain, has led to further decreases in maize prices.

While drought ravaged the country and caused declining growth in the agricultural sector, industry grew by 3.5% on the back of 14.1% growth in the construction sub-sector, which represents 4.2% of GDP. Growth in industry may have been impressive, but it is the services sector that continues to drive the Kenyan economy. Services grew by 4.2%, led by communications, transport and trade. Kenya's tourism industry also rebounded strongly to approximately 1 million tourists in 2009. Domestic demand in these sectors grew at 4%, leading Kenya out of its economic crisis.

Analysts and traders unanimously agree that poll violence is the worst outcome for Kenya's developing economy.¹¹³ Following the post-election crisis in 2008, growth fell to 1.6% from 7.1% in 2007. Tourism was one of the hardest hit sectors: earnings fell 19.4%,

¹¹² Iyabo Masha, 'IMF shocks loan, policy changes help Kenya's recovery,' IMF Survey Magazine, 8 January 2010, <http://www.imf.org>.

¹¹³ Jeremy Clarke, 'Economic impact of Kenya's referendum,' Reuters, 28 June 2010,

after the best year in its history in 2007. Any new violence in Kenya will also negatively affect trade and transport with its land-locked neighbours, especially Rwanda and Uganda.

Together with the emerging recovery of the global economy, a relatively stable domestic environment and pro-active Government policies gave rise to optimism that the Kenyan economy could grow by 4% in 2010 from the 2.6% in 2009 and 1.6% in 2008.¹¹⁴ In its report, the World Bank raised concerns that an infrastructure deficit constrains exports. The report focuses on the port of Mombasa, probably East Africa's most important infrastructure asset, as exemplifying Kenya's infrastructure deficit. Despite some improvements, port reforms have not kept up with the momentum achieved in other African countries. It still takes 20 days to bring a container from Mombasa to Nairobi, a longer period than it takes to ship the same container from Singapore to Mombasa. In addition, the overall volumes handled in Mombasa are low by international standards, representing only 2% of the volumes handled by Singapore. It is in these "soft areas", where the port of Mombasa could make the biggest gains. To address deficits, the World Bank suggests the establishment of a "landlord port" and the enabling of full 24-hour port operations.

In addition to exports, the manufacturing sector presents great challenges for Kenya's economy. Stagnating at around 11% of the economy, the sector has dropped from second to fourth place in economic importance over the last decade. While tradable sectors, such as agriculture and manufacturing have performed poorly, non-tradable sectors, such as services and construction, have fared better. In 2004, transport & telecommunications became Kenya's second largest sector and in 2007, wholesale and retail trade surpassed manufacturing as a percentage of GDP.

The IMF also suggests that if the Government's vision of accelerating economic growth in the medium-term and making Kenya a middle-income country by 2030 is to be kept on

¹¹⁴ Eric Ombok, 'Kenya Economy May Grow 4% in 2010, Accelerate in 2011', Businessweek, 3 June 2010, <http://www.businessweek.com>.

target, additional investment in infrastructure is required. In addition, strong implementation of structural reforms is crucial to achieving these aims.¹¹⁵

Financial sector stability and development would furthermore benefit from faster progress in addressing shortcomings in the supervisory and regulatory framework of both the banking system and the capital market. The IMF suggests that enactment of the Banking Act (Amendment) Bill will strengthen the Central Bank's position by authorizing consolidated supervision and prompt corrective action. Capital market depth and regulation would be further enhanced by the enactment of the Deposit Insurance, National Payment System, and Demutualization of the Stock Exchange Bills.

Kenya registered a sterling economic performance in the five years to January 2008, which was brought to an abrupt end by controversy over the election result, the onset of global economic recession, increased food and fuel prices and severe drought. The strong gains made in 2009 and the predicted growth of a healthy 4% in 2010 is evidence of the resilience of the Kenyan economy.

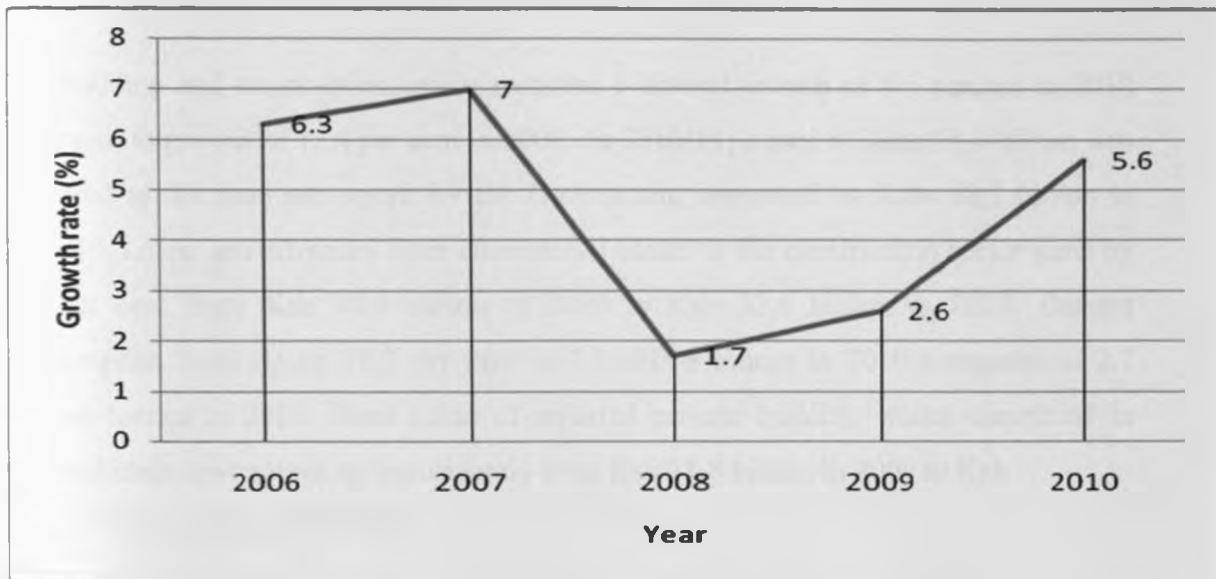
3.2 The 2011 Economic Survey Report

The 2011 Economic Survey Report was launched by the Minister for Planning, National Development and Vision 2030, Hon. Wycliffe Oparanya. The Report presents the economic performance, over a period of five years, of various sectors in the economy.¹¹⁶ The 2011 Economic Survey Report revealed that, Real GDP expanded by 5.6 per cent in 2010 compared to a growth rate of 2.6 per cent in 2009 (see figure 2 below). All sectors of the economy recorded positive growths of varying magnitudes. The main sectors driving the economy were agriculture and forestry, wholesale and retail trade, transport and communication, manufacturing and financial intermediation. The growth in these sectors was influenced by improved weather conditions, low inflationary pressure, low interest rates, stable macroeconomic environment, and increased credit to the private sector as well as higher investments.

¹¹⁵ Iyabo Masha, 'IMF shocks loan, policy changes help Kenya's recovery,' IMF Survey Magazine, 8 January 2010, <http://www.imf.org>.

¹¹⁶ Ministry of State for Planning, National Development and Vision 2030

Figure: 3: GDP Growth Rate



Source: Kenya National Bureau of Statistics

3.2.1 Performance per sector

Regarding international trade, the value of total exports grew by 18.8 per cent from Kshs 344.9 billion in 2009 to Kshs 409.8 billion in 2010. The value of imports grew by 20.2 per cent to Kshs 947.4 billion in 2010, compared to a marginal growth of 2.3 per cent in 2009. Consequently, Kenya's trade balance worsened by 21.3 per cent in 2010 compared to the earlier deterioration of 4.1 per cent in 2009. However, the country's trade balance worsened in 2010. The current account balance widened to a deficit of Kshs 199.2 billion in 2010 from a deficit of Kshs 129.2 billion in 2009. Total transfers amounted to Kshs 187.6 billion in 2010 of which the remittances in flow to the country were Kshs 54.2 billion. The capital and financial account recorded a surplus of Kshs 187.4 billion in 2010 down from a surplus of Kshs 200.0 billion recorded in 2009. In addition, the overall balance of payments deteriorated from a surplus of Kshs 75.2 billion in 2009 to a surplus of Kshs 12.2 billion in 2010. This deterioration was on account of decreased net capital inflows coupled with deterioration in the current account balance. On education,

government allocation to the education sub sector was Kshs 193.3 billion in 2010/2011 budget.¹¹⁷

The building and construction sector recorded a slowed growth of 4.5 percent in 2010 compared to growth of 12.4 per cent in 2009. In 2010/11, a total of Kshs 91.0 billion was allocated to the road sub sector by the Government compared to Kshs 68.1 billion in 2009/10. Loans and advances from commercial banks to the construction sector grew by 7.3 per cent from Ksh 30.4 billion in 2009 to Ksh 32.6 billion in 2010. Cement consumption went up by 16.2 per cent to 3.1million tonnes in 2010 compared to 2.7 million tonnes in 2009. Total value of reported private building works completed in selected main towns went up significantly from Ksh 21.8 billion in 2009 to Ksh 37.3 billion in the year 2010/2011.

Transport and Communication sector recorded a growth of 5.9 per cent in 2010 compared to 6.4 per cent in 2009. The growth was mainly driven by expansion of transport and storage sub sector. Growth in the post and telecommunication sub sector slowed to 4.4 per cent in 2010 compared to a rapid expansion of 10.0 per cent in 2009. The mobile subscriber base reached 20.1 million in 2010 from 17.4 million in 2009. Revenue earned from cargo transportation in the railway sub sector decreased from Kshs 4.3 billion in 2009 to Kshs 4.1 billion in 2010. Government directive to phase out 14-seater public service vehicles from the year 2011 started to take effect in 2010 with new registration of matatu minibus declining by 19.7 per cent. Consequently, the number of newly registered buses and coaches went up by 19.6 per cent.

The annual average price of oil increased to US\$ 79.16 per barrel in 2010 compared to US \$ 62.65 per barrel in 2009. The high international oil prices translated to higher petroleum prices in the international market which led to higher petroleum prices in the domestic market. Total demand of petroleum products grew by 4.3 per cent from 3,610.8 thousand tonnes in 2009 to 3,760.7 thousand tonnes in 2010. Installed capacity for electricity expanded by 7.7 per cent to 1,412.2 MW in 2010 from 1,311.5 MW in 2009. Consequently, total electricity generation increased by 7.2 per cent to 6,975.8 million

¹¹⁷ Kenya National Bureau of statistics. Kenya Economic Survey 2011

increased by 7.2 per cent to 6,975.8 million KWh in 2010 compared to 6,507.2 million KWh in 2009. The growth in electricity generation was mainly driven by 49.3 per cent increase in production from hydro power sources associated with improved water levels at the seven forks dams where much of Kenya's hydroelectric power is produced. Total Electricity consumption registered a growth of 6.0 per cent from 5,428.6 million KWh in 2009 to 5,754.7 million KWh in 2010. The number of connections under the Rural Electrification Programme rose by 22.3 per cent from 205,287 as at June 2009 to 251,056 as at June 2010.

The agricultural sector recorded a real growth of 6.3 per cent in 2010 compared to 2.6 per cent in 2009. The turnaround was primarily due to favourable weather experienced in 2010 and government intervention through provision of subsidized seeds and fertilizer as well as improved prices for exports such as tea and coffee. Maize, wheat, rice, tea, sisal and pyrethrum are among the commodities whose production improved significantly.

The manufacturing sector grew by 4.4 per cent in 2010 compared to 1.3 per cent in 2009. The growth was due to reliable power supplies that bolstered power generation, favourable tax policies including the removal of duty on capital equipment and some raw materials, increased credit to the manufacturing sector, increased availability of raw agricultural materials, and, growth in the regional market – EAC and COMESA. The sector of Transport, Storage and Communication recorded a growth of 5.9 per cent in 2010 compared to 6.4 per cent in 2009. The mobile subscriber base reached 20.1 million in 2010 from 17.4 million in 2009. The number of newly registered buses and coaches rose by 19.6 per cent.

The financial intermediaries' performance was exemplary during the period under review. The sector posted a more robust expansion of 8.8 percent. The Central Bank Rate (CBR) was lowered twice with a view of lowering the cost of credit. Banks lowered their interest rates, which in turn benefited the private sector through access to cheaper credit.

In general, all sectors recorded a positive growth of varying magnitudes as shown in the table 1 below:

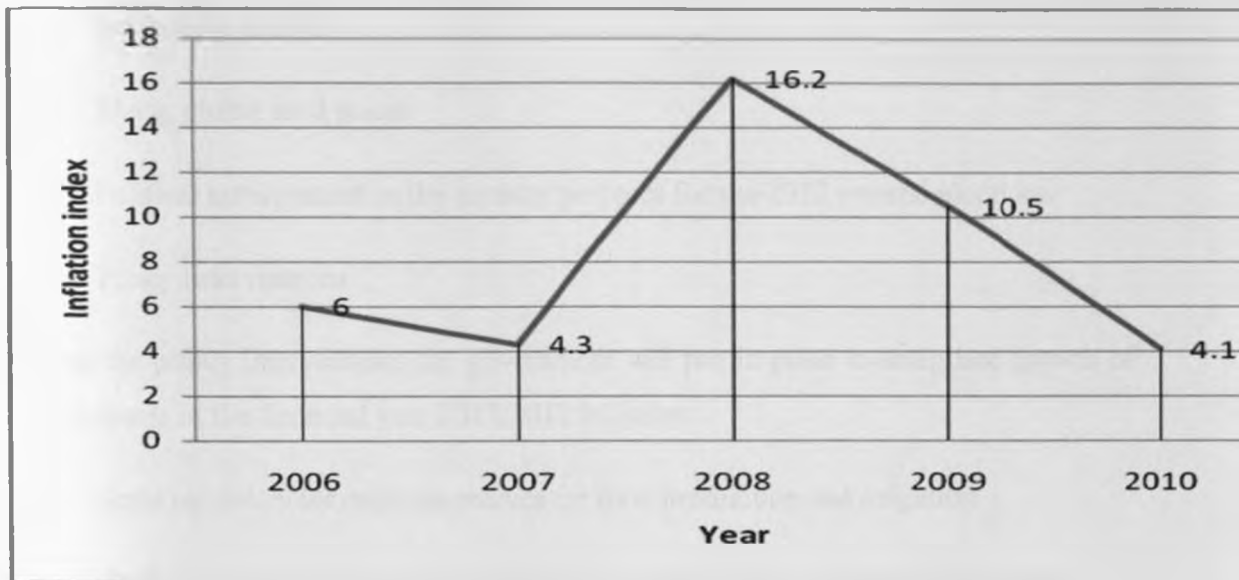
Table 1: Growth of main sectors driving the Economy in Kenya

| SECTOR | GROWTH INDEX | |
|---------------------------|--------------|------|
| | 2009 | 2010 |
| Agriculture & Forestry | -2.6 | 6.3 |
| Wholesale & Retail Trade | 3.9 | 7.8 |
| Transport & Communication | 4 | 6.9 |
| Manufacturing | 1.3 | 4.4 |
| Financial Intermediation | 4.6 | 8.8 |

Source: Kenya National Bureau of Statistics

Inflation was contained within the Government's target of 5.0 per cent in 2010. The average annual inflation was 4.1 per cent in 2010 down from a high of 10.5 per cent recorded in 2009. The decline in the inflation rate was mainly on account of favourable weather which led to low food prices emanating from improved agricultural production and competition between the mobile telephone operators which resulted in reduction in calling rates. Figure 3 below shows the trend in economic inflation.

Figure 4: Trend in economic inflation



Source: Kenya National Bureau of Statistics

3.2.2 Employment

In the year 2010, the labour market recorded 503,000 new jobs. This is attributed to improved economic conditions as well as increased access to affordable credit from banks through the Women Enterprise Fund and the Youth Development Fund which aided in starting and expanding businesses, thereby generating jobs. In the modern sector, 62.6 thousand jobs were created, the bulk of which were in building and construction, transport and communication, wholesale and retail trade, restaurants and hotels. The informal sector created an additional 440.9 thousand jobs. Real GDP expanded by 5.6 per cent in 2010 compared to a growth of 2.6 per cent in 2009.

3.2.3 Economic outlook for financial year 2011/2012

The domestic economy is likely to maintain a positive growth, albeit at a decelerated rate of between 3.5 and 4.5 per cent.

Risks likely to shape economic growth include-

- High international oil prices

- Fluctuations in the exchange rate
- Inadequate rainfall
- Rising global food prices
- Political environment as the country prepares for the 2012 general elections
- Policy interventions

Among the policy interventions the government will put in place to safeguard growth of the economic in the financial year 2011/2012 includes:

- Scale up policy for more incentives for food production and irrigation
- Widen social protection policies and relief for 4 million vulnerable Kenyans
- Better coordination of key players in production and distribution in the food sector
- Fast track implementation of the National Land Policy to ensure effective land utilization
- Remove, for a limited time, tariffs on imported grain
- Actualize the 8 million strategic grain reserves
- Maintain reductions in taxes on diesel and kerosene
- Accelerate Strategic Oil Reserves Policy
- Accelerate reforms in the railway sub sector and Mombasa Port, as well as construction of the Lamu Port
- Strengthen policies on youth employment and MSE sector
- Continued infrastructure development
- Control population growth

- Continue to improve the business environment by reducing the cost of doing business
- Increase funding for Research and Development
- Fast-track the implementation of the New Constitution, especially the critical bills.

CHAPTER FOUR

ECONOMIC RELATIONS BETWEEN KENYA AND THE REST OF THE WORLD

An important factor in Kenya's development has been its interaction with various regional trading partners. The geography of its international trade varies significantly, depending on the type of good, and is closely associated with the presence of international trade agreements. It exports most of its agricultural products to the European Union and most of its manufactured goods to Sub-Saharan African countries, mainly to members of the Common Market for Eastern and Southern Africa (COMESA). Export markets include Uganda, the United Kingdom, Tanzania, the Netherlands, and the United States, Sudan, Somalia, the Democratic Republic of the Congo, Rwanda, Zambia, and Ethiopia.¹¹⁸ The bulk of Kenya's non-oil imports are manufactured goods. The three major countries of origin are India, China, and the United States, accounting together for one-third of non-oil exports. Developed countries such as United States, China, Japan, the United Kingdom, Germany, and France are significant suppliers of Kenyan imports.

4.1 Regional trade agreements

Trade diplomacy has been a key factor in shaping the structure of Kenya's international trade flows. The country has negotiated a number of regional trade agreements that have shaped its international trade. Kenya is a founding member of the World Trade Organization (WTO) and a signatory to the African, Caribbean, and Pacific-European Union (ACP-EU) Cotonou Partnership Agreement. It is also a beneficiary of the Generalized System of Preferences and the AGOA initiative of the United States. Regionally, Kenya is a member of the East Africa Community, the Common Market for Eastern and Southern Africa, the Intergovernmental Authority on Development, and the Cross-Border Initiative. Kenya has also signed a number of bilateral trade agreements.

¹¹⁸ Zepeda, E., Chemingui, M., Bchir, H., Karingi, S., Onyango, C., & Wanjala, B. (2009). The Impact of the Doha Round on Kenya. Carnegie Endowment for International Peace.

4.1.1 The East Africa Community

The East Africa Community (EAC) was launched in 1999 by Kenya, Uganda, and Tanzania, with the aim of widening and deepening political, economic, and social cooperation among partner states.¹¹⁹ The EAC launched a customs union in January 2005, with a three- band common external tariff regime: 0 percent for capital goods and raw materials, 10 percent for semi-processed goods, and 25 percent for finished products. Rwanda and Burundi formally joined the EAC in July 2007, bringing its size to 115 million people and a combined GDP of US\$40 billion. Objective of the EAC is to develop policies and programs for widening and deepening cooperation among the Partner States in political, economic, social and cultural fields, research and technology, defense, security and legal and judicial affairs. A key guiding principal in the achievement of this objective is people-centered and market-driven cooperation.¹²⁰

Kenya's exports to the East African region have been increasing. The EAC constitutes Kenya's single largest export destination, accounting for about 23 percent of its total exports.¹²¹ Uganda is the largest destination of Kenyan products, accounting for 60% total exports to the region, while Tanzania is the largest exporter to Kenya within the EAC region with 65%. Major exports to Uganda include mineral fuels, mineral oils and related products (salt, sulphur, earths and stone and plastering materials), paper and paperboard, plastics and articles thereof, iron and steel, beverages, spirits and vinegar, and pharmaceutical products. On the other hand, exports to Tanzania compose largely of wood and articles of wood, wood charcoal, paper and paperboard, articles of paper pulp, cotton, copper and articles thereof, textile articles, sets, worn clothing and worn textile articles.

While Uganda and Tanzania are among the leading export destinations for Kenyan exports, it is worth noting that a big percentage of the exports to the two countries constitute re-exports. For instance, Kenya's re-exports to Uganda reached about 60% in

¹¹⁹ EAC (2002), *The Treaty for the Establishment of the East African Community*. Published by the EAC Secretariat, Arusha, Tanzania.

¹²⁰ Mugisa, E., Onyango, C., & Mugoya, P. (2009). *An Evaluation of the Implementation and Impact of the East African Community Customs Union*, Final Report.

¹²¹ COMTRADE Database, 2008, available at <http://comtrade.un.org>

2003 prior to the customs union, but stabilized at about 10% of total exports in recent years.¹²² The main re-export products have been petroleum products, chemicals, machinery, transport equipments and manufactured goods. On the other hand, re-exports to Tanzania accounted for about 45% of total exports in 2003 and has since been declining in the recent past reaching 6% in 2007. Major re-exports to Tanzania have been machinery & transport equipments, chemicals and manufactured goods. Likewise, imports into Kenya from the Partner States have been increasingly marginally over the recent years. Tanzania is the largest exporter to Kenya and has seen her import figures rising over the years. Major imports from Tanzania include wood and articles of wood; paper and paper products; cotton; copper and articles thereof and plastics and articles thereof. The major imports from Uganda include animal and vegetable fats, cereals, cotton, oil seeds and oleaginous fruits, furniture and wood and wood products.¹²³

4.1.2 The Common Market for Eastern and Southern Africa

The Common Market for Eastern and Southern Africa (COMESA) is a regional integration grouping of African States (Burundi, Comoros, Democratic Republic of Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Libya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia and Zimbabwe), which have agreed to promote regional integration through trade development and to develop their natural and human resources for the benefit of their people.¹²⁴ The Common Market for Eastern and Southern Africa, formerly the Preferential Trade Area for Eastern and Southern African States was established in 1994.

With a membership of twenty countries, a combined population of about 400 million, and a GDP of US\$270 billion, COMESA is the largest trading bloc in Africa. The COMESA Free Trade Area, launched in December 2000, has thirteen member states. In 2008, membership in the COMESA Free Trade Area was extended to the EAC and to the Southern African Development Community. Member states have agreed on a three band

¹²² Republic of Kenya (2008) Statistical Abstract. Published by the Kenya National Bureau of Statistics, Nairobi, Kenya.

¹²³ Republic of Kenya (2008) Statistical Abstract. Published by the Kenya National Bureau of Statistics, Nairobi, Kenya.

¹²⁴ Ministry of Trade and Industry (2011), COMESA Desk, Kenya.

tariff regime: 0 percent for raw materials and capital goods, 10 percent for intermediate products, and 25 percent for finished products. Free trade is important for the promotion of intra-COMESA Trade. Some of the investment opportunities in Kenya for COMESA member are in areas such as agriculture and related activities, infrastructure, manufacturing, Services such as construction and housing; training; health care, financial services and ICT. Other countries in the COMESA region also offer Kenyans an opportunity to invest. There are for example immense investments opportunities in Sudan, especially Southern Sudan where reconstruction of the country has just begun and Rwanda with its improved investment climate.¹²⁵

4.1.3 The African, Caribbean, and Pacific–European Union Cotonou Partnership Agreement

The ACP- EU Cotonou Partnership Agreement (formerly the Lomé Convention) was signed in 2000. Intensive negotiations for comprehensive economic partnership agreements (EPAs) between the EU and ACP countries during 2007 concluded with the signatures of forty- eight African countries and thirty- one Caribbean and Pacific countries.¹²⁶ Moreover, the EPA with the CP countries is more far reaching than the EPAs signed with the African countries including Kenya. The EPA may present some challenges to the ACP. For example, it might force countries to manage expected losses in fiscal revenue without proper assistance, it might increase competition under the principle of reciprocity, and it might impose market access constraints for agricultural and non-agricultural products.

4.1.4 The Intergovernmental Authority on Development ((IGAD)

The Intergovernmental Authority on Drought and Development was formed in 1986 with an initial mandate of issues concerning droughts and desertification. In 1996, it was revitalized and renamed the Intergovernmental Authority on Development (IGAD), with a broader mandate of conflict management and resolution, humanitarian affairs,

¹²⁵ Ministry of Trade and Industry (2011), COMESA Desk, Kenya.

¹²⁶ Zepeda, E., Chemingui, M., Bchir, H., Karingi, S., Onyango, C., & Wanjala, B. (2009). The Impact of the Doha Round on Kenya. Carnegie Endowment for International Peace

infrastructure development, food security, and the environment. IGAD's member states, including Kenya, have committed to implementing COMESA's trade cooperation measures.¹²⁷

IGAD aims to expand the areas of regional co-operation, increase the members' dependency on one another and promote policies of peace and stability in the region in order to attain food security, sustainable environment management and sustainable development. The IGAD strategy is to attain sustainable economic development for its member countries. Regional economic co-operation and integration are given special impetus and high priority to promote long-term collective self-sustaining and integrated socio - economic development. The leading principles of the IGAD strategy are stipulated in the agreement establishing IGAD, but are also mindful of the UN Charter and AU Constitutive Act.

4.1.5 The Cross- Border Initiative

The Cross- Border Initiative (CBI) was established in August 1993 among fourteen participating countries in Eastern and Southern Africa and the Indian Ocean region, and with four multilateral co-sponsors: the International Monetary Fund, the World Bank, the European Union, and the African Development Bank.¹²⁸ The Initiative reflects extensive discussions between the co-sponsors, the relevant regional institutions and public and private sector representatives of most of the Eastern and Southern African States (Burundi, Comoros, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Namibia, Reunion, Rwanda, Swaziland, South Africa (in observer status), Tanzania, Uganda, Zambia and Zimbabwe).

The CBI's common policy framework aims to facilitate cross- border economic activity by eliminating barriers to the flow of goods, services, labour, and capital. It also works to help integrate markets by coordinating reform programs in several key structural areas, supported by specific macro-economic policies. Within the CBI, Kenya has indicated a

¹²⁷ Ibid

¹²⁸ Zepeda, E., Chemingui, M., Bchir, H., Karingi, S., Onyango, C., & Wanjala, B. (2009). The Impact of the Doha Round on Kenya. Carnegie Endowment for International Peace

desire to accelerate tariff reductions and to reduce the number of non-zero tariff bands to no more than three.

4.1.6 Bilateral Trade Agreements

Kenya has signed a number of bilateral trade agreements in pursuit of market access for its products. Its bilateral trading partners include Algeria, Argentina, Bangladesh, Belarus, Canada, China, Comoros, the Democratic Republic of Congo, Cyprus, Djibouti, Eritrea, India, Iraq, Lesotho, Liberia, Malaysia, Mauritius, Nigeria, Pakistan, Russia, Rwanda, Saudi Arabia, Somalia, South Korea, Sudan, Swaziland, Tanzania, Thailand, Turkey, Ukraine, Zambia, and Zimbabwe. Some of Kenya's agreements with these nations have been reviewed in light of subsequent regional and multilateral trade commitments.

4.1.7 The African Growth and Opportunity Act (AGOA)

The African Growth and Opportunity Act (AGOA), which was enacted in 2000 by the U.S. government, consist of regional initiatives in United States trade policy that are based on the general philosophy of "trade, not aid" as the chief tool for promoting economic development.¹²⁹ The intention is to offer trade preferences to the beneficiary countries as a complement to foreign aid, and encourage them to adopt reforms in their economic, investment and trade policies. The most immediate benefit that it extends to sub-Saharan African countries is expanded product coverage under the Generalized System of Preferences (GSP), as well as tariff- and quota-free exports of textile and apparel products to the United States.

The African Growth and Opportunity Act offer Sub- Saharan countries, including Kenya, unilateral access to the U.S. market. In 2002, AGOA exports constituted more than 77 percent of Kenya's total exports to the United States, with textiles and apparels as the

¹²⁹ United Nations (2003) April 2003 The African Growth and Opportunity Act: A Preliminary Assessment. A report prepared for the United Nations Conference on Trade and Development, New York and Geneva.

dominant category.¹³⁰ A July 2004 amendment to AGOA extends its preferential access until September 2015.

4.1.8 The Generalized System of Preferences

The Generalized System of Preferences (GSP) aims to promote economic growth in developing countries by granting tariff reductions (which might go as low as zero) that are better than most-favored-nation (MFN) rates for beneficiary countries. Currently, there are thirteen national GSP schemes. Kenya is a beneficiary of eleven GSP schemes, with Bulgaria, Canada, Estonia, the European Union member states, Japan, New Zealand, Norway, Russia, Switzerland, Turkey, and the United States.

4.2 Kenya- China relations

Kenya-China relations date back to 14 December 1963, two days after the formal establishment of Kenyan independence, when China became the fourth country to open an embassy in Nairobi. Military exchange between the two countries has been increasing in the past decade.¹³¹ General Liu Jingsong, commander of the Lanzhou Military Region, led China's first military delegation to Kenya in December 1996; Major General Nick Leshan, commander of the Kenyan air force, paid a return visit in 1997. Kenyan president Mwai Kibaki visited Beijing in August 2005.¹³²

Although China embraced communism and Kenya at independence adopted a capitalist system, their relations have largely remained cordial. China was the fourth country to recognize Kenya's independence in 1963 when the two countries exchanged diplomatic representations.¹³³ The Sino-Kenya relationship, first established in 1964 was centered on promoting trade between the two countries. The trade component of this relation was further reinforced in 1978, when under the leadership of Deng Xiaoping, China started implementing trade reforms and outward oriented programs. Since the China-Africa

¹³⁰ AGOA (2007). Comprehensive Report on U.S. Trade and Investment Policy Towards Sub-Saharan Africa and Implementation of the African Growth and Opportunity Act. Available at <http://www.agoa.info/>.

¹³¹ Xinhua News Agency (2003-12-11). Kenya, China Mark 40-year Diplomatic Ties.

¹³² People's Daily (2005-08-19). China to promote cooperation with Kenya: Chinese premier.

¹³³ Kamau P. (2007). Kenya: A case study-The Developmental Impact of Asian Drivers on Kenya with Emphasis on Textiles and Clothing Manufacturing. Mimeo.

Forum was established in 2000, Kenya has remained an active member of the forum. Different Ministers have represented the Kenyan government in all the Ministerial Conferences of the China-Africa Forum.¹³⁴

The exchange of official visits at the high levels of head of states, ministers, senior government officials and business delegations has strengthened relations between China and Kenya. Kenya's first high profile delegation to China was in 1964 led by the then Vice- President Jaramogi Oginga Odinga. In 1980, the then Kenyan President Daniel arap Moi led another high profile delegation to China, followed by others in 1988 and 1994. In August 2005, President Mwai Kibaki led a Kenyan delegation to China which resulted in the signing of several bilateral agreements. In May 1996, the former President of China Jiang Zemin made a state visit to Kenya, which marked the first ever visit to Africa by a Chinese President. In November 2004, Wu Bangguo paid a visit to Kenya heading a Chinese delegation. In April 2006, the Chinese President, Hu Jintao visited Kenya in his tour of five African countries as the head of state. In the past five years, over fifteen Kenyan ministers have visited China since 2002. Similarly, many other government officials have also made official trips to China.¹³⁵

Bilateral relations have been developing smoothly with the traditional friendship continuously deepened and friendly cooperation in all areas increasingly expanded. Bilateral economic and trade relations have scored new progress and both sides have made rapid headway in cooperation in the areas of electric power, communications, investment and project contract, achieved new results in humanities exchanges and maintained close consultations and cooperation in international affairs. The bilateral economy and trade agreements signed between China and Kenya include: "Agreement on Economic and Technological Cooperation between the People's Republic of China and the Republic of Kenya", "Agreement on Trade between the People's Republic of China and the Republic of Kenya" (1978) and the agreement on promotion and protection of investments in 2001. The two countries have signed a total of 12 bilateral accords over

¹³⁴ Ibid

¹³⁵ Ministry of Foreign Affairs, Kenya (2006) A Brief Prepared for Institute for Development Studies, University of Nairobi, SEPTEMBER 2006

the past three years which have covered a variety of fields including the economy, technology, energy, tourism, health, aviation, the press, archaeology and education.¹³⁶

In 2006, Kenya and China signed six agreements signaling closer economic and technical cooperation between the two countries during a meeting held at the Great Hall of the People in Beijing between President Kibaki and his host President Hu Jintao. The signed agreements included Economic and Technical Cooperation, agreement on the provision of the concessional loan by China to Kenya and the Air Services Agreement which grants Kenya Airways landing rights in several cities in China. Also signed were agreements on Radio Cooperation between the State Administration of Radio, Film and Television of China and the Ministry of Information and Communications of Kenya and a collaborative agreement between General Administration of Quality Supervision Inspection and Quarantine of China and Kenya's Bureau of Standards. Appendix A provides a detailed account of the agreements signed.¹³⁷

Bilateral trade amounted to US\$186.37 million in 2002; China exported US\$180.576 million to Kenya, while only importing US\$5.798 million of Kenyan goods, mainly black tea, coffee, and leather.¹³⁸ Early in 2006 Chinese President Hu Jintao signed an oil exploration contract with Kenya; the latest in a series of deals designed to keep Africa's natural resources flowing to China's expanding economy. The deal allowed for China's state-controlled offshore oil and gas company, CNOOC Ltd., to prospect for oil in Kenya, which is just beginning to drill its first exploratory wells on the borders of Sudan and Somalia and in coastal waters. In April 2007, the Jinchuan Group, a state-owned metal manufacturing group, became the first Chinese company to enter Kenya's mining sector, purchasing a 20% stake in Tiomin Kenya.¹³⁹

¹³⁶ Ministry of Foreign Affairs, Kenya (2006) A Brief Prepared for Institute for Development Studies, University of Nairobi, SEPTEMBER 2006

¹³⁷ Ibid

¹³⁸ Ministry of Foreign Affairs of the People's Republic of China. (2003). Kenya: Bilateral Relations.

¹³⁹ Onyango, J., & Odhiambo, A. (2007). Kenya: Attention Shifts to China after Latest Catch. Business Daily (2007-10-30), Nairobi

4.2.1 China's Aid to Kenya

China's assistance to Kenya is exclusively project based. Since the establishment of the diplomatic relations, the projects of aid and assistance provided by China to Kenya have been diverse. China currently gives both monetary and non-monetary aid to Kenya. Development aid from China supports investment in infrastructure, equipment and plant; academic training; technical training; human relief; and tariff exemptions. China has given Kenya grants and loans for infrastructure, plant and equipment. These are mainly in road construction projects, modernization of power distribution, rural electrification, water, renovation of international sports centre, medical and drugs for fighting malaria, and construction of a malaria research centre. China has for a long time awarded scholarships to Kenyan students wishing to undertake their studies in China in diverse fields.¹⁴⁰

China has extended to Kenya, loans and grants for a number of projects including; the Moi International Sports Complex project in Kasarani, supply of medical equipment and drugs, the upgrading of the Moi Referral Hospital in Eldoret, Concessional Loans for construction of various roads, including Kipsigak – Serem – Shamakhokho road, Kima/Emusustwi Road and the Gambogi-Serem road and a Maize Flour Processing Project in Bomet town.¹⁴¹

¹⁴⁰ Onyango, J., & Odhiambo, A. (2007). Kenya: Attention Shifts to China after Latest Catch. Business Daily (2007-10 30), Nairobi

¹⁴¹ Zafar Ali (2007). The Growing Relationship between China and Sub-Saharan Africa: Macroeconomic, Trade, Investment and Aid Links. World Bank Research Observer, Vo.22, Issue 1, 2007.

CHAPTER FIVE

KENYA'S INFRASTRUCTURE

5.1 Regional fruits of Kenya's infrastructure development

Economic growth and development are a function of a multiplicity of multifaceted, complex and interlinked variables. In varying degrees, a plethora of impediments to growth has been identified in the economic literature. Frequently, economic infrastructure is placed high on the hierarchy of importance. Endeavors to attain the Millennium Development Goals (MDG) imply that an enabling environment is created for the productive sector to correct the imbalance between the social and productive sectors in a manner that builds for the future by investing for a higher long run growth path.¹⁴² To be sure, improved economic infrastructure will enhance the international competitiveness of African economies and markets.

Investment in economic infrastructure reduces production costs and enhances private sector returns.¹⁴³ Economic infrastructure forms the spine around which other development programmes flourish. In an African context, the weakness of this spine has created impediments to diversification and growth. The deterioration in economic infrastructure has damaged the ability of least developed countries to develop. Two global developments have solidified the importance of economic infrastructure over the past two decades: first, the dominant role of the public sector as provider of infrastructure has diminished since the 1980s and, second, broad based privatization of infrastructure industries has increasingly taken place.

¹⁴² Manuel, T. A. 2006. Ministerial Roundtable Discussions on Infrastructure Development and Regional Integration: Issues, Opportunities and Challenges, Tuesday 16 May 2006. National Treasury, Republic of South Africa

¹⁴³ Black, P. A. Calitz, E. Steenekamp, T. J. 2003. Public Economics for South African Students (second edition). Oxford University Press. Cape Town.

Africa's economic infrastructure investment has remained dislocated with the pace of urbanization, and rural infrastructure development remains lacking because of poor institutional capacity.¹⁴⁴ By and large, Africa's infrastructure is relatively costly: for instance, power and road freight costs are approximately three times higher than in the US and road freight delays are around three times as long as in Asia. Moreover, the expense and interruptions collectively occur in an environment of low access to and reliability of power.¹⁴⁵ In many African countries, economic infrastructure remains insufficient to support the magnitude of growth that the continent requires to integrate into the global economy as mature, market driven and diversified economies.¹⁴⁶ For this reason, the rehabilitation and maintenance of existing infrastructure, creation of new infrastructure, and strengthening of institutional capacity for infrastructure development remain priority areas for action.

There are a few dominant channels through which economic infrastructure improvements manifest in a general uplift of economic activity. The most direct channel from infrastructure to growth involves the productivity enhancing effect of improvements in infrastructure through expanding the capacity of that specific factor of production. In addition, an increase in infrastructure stock indirectly raises the productivity of other factors of production. For instance, providing access to certain services, like electricity, is likely to yield a positive productivity effect on entrepreneurs and businesses, while simultaneously improving the investment environment for other infrastructure projects. Importantly, all instances of successful development are ultimately the collective result of individual decisions by entrepreneurs to invest in new ventures.¹⁴⁷ Improved infrastructure has the potential not only to improve the living conditions of the poor

¹⁴⁴ United Nations. 2006. Human development report. United Nations. New York.

¹⁴⁵ Rugamba, A. 2007. Investing in Economic Infrastructure: the Role of Development Finance Institutions presented at the African Policy Seminar on Fiscal Elements of Growth and Development Durban, 7 September 2007. T

¹⁴⁶ Manuel, T. A. 2006. Ministerial Roundtable Discussions on Infrastructure Development and Regional Integration: Issues, Opportunities and Challenges, Tuesday 16 May 2006. National Treasury, Republic of South Africa

¹⁴⁷ Rodrik, D. 2000. Institutions for highquality growth: what are they and how to acquire them. National Bureau of Economic Research. NBER Working Paper No., 7540. Cambridge

directly but also to reduce the costs of doing business and encourage investment in productive assets.¹⁴⁸

Above and beyond the direct factor accumulation impact of economic infrastructure on growth, some indirect, yet notable repercussions are worth highlighting. For a start, improvements in the stock of economic infrastructure in poorer regions plausibly reduce private capital adjustment costs and lower production and transaction costs.¹⁴⁹

Improvements in the stocks of infrastructure engender more reliable service supply and reduce the need for firms to invest in substitutes that hedge against potential service interruptions, thereby freeing resources for private productive investment.¹⁵⁰ Labour productivity enhancements are also likely as a result of reductions in time wasted commuting to work and the associated stress as well as of the more efficient ways of organizing work time as a result of improved information and communication. Somewhat related, numerous micro econometric studies have documented that better infrastructure induces improvement in health and education, which improve the human capital stock.¹⁵¹

Infrastructure investments are positively associated with the attainment of economies of scale by lowering transport costs or improving information flows.¹⁵² Private sector participation in economic infrastructure has the potential to reshape the composition of public expenditure, which may lead to the elimination of subsidies in the provision of infrastructure services, generate privatization revenues and create fiscal flexibility.¹⁵³

¹⁴⁸ Manuel, T. A. 2006. Ministerial Roundtable Discussions on Infrastructure Development and Regional Integration: Issues, Opportunities and Challenges, Tuesday 16 May 2006. National Treasury, Republic of South Africa

¹⁴⁹ Agénor, P. R. Moreno-Dodson, B. 2006. Public infrastructure and growth: new channels and policy implications. World Bank Policy Research Working Paper No., 4064. World Bank. New York.

¹⁵⁰ Straub, S. 2008. Infrastructure and growth in developing countries: recent advances and research challenges. The

World Bank Development Research Department. World Bank. New York.

¹⁵¹ Galiani, S. Gertler, P. Schargrodsky, E. 2005. Water for life: the impact of privatization of water services on child mortality. *Journal of Political Economy*, Vol., 113.

¹⁵² Duggal, V. Saltzman, C. Klein, L. 2007. Infrastructure and productivity: an extension to private infrastructure and its productivity. *Journal of Econometrics*. Cambridge.

¹⁵³ Calderón, C. Servén, L. 2004. The effects of infrastructure development on growth and income distribution. Central Bank of Chile. Working Papers No., 270.

Numerous governments across the continent have earned the fiscal space to accelerate spending on measures that support poverty alleviation and vital services. However, governments are balancing upward wage pressures against the need for investments in economic and social infrastructure, such as power, road, rail and ports. To alleviate the fiscal pressure, development requires the mobilization of private investment for identified infrastructure bottlenecks that present a formidable challenge to economic growth and development.

Aside from the effects of infrastructure development on growth, productivity and output, another strand of development literature stresses the importance of economic infrastructure for its encouraging effects on income inequality. Infrastructure development can potentially have a disproportionately larger impact on the human capital of the poor through the job opportunities and associated income and security it implies. Infrastructure development has a positive impact on the income and welfare of the poor by connecting underdeveloped areas to core economic activities, which allows them to access additional productive opportunities.¹⁵⁴

In many instances, development strategies have been framed by simply importing a top down blueprint from more mature economies, based on linear assumptions of development and modernization. Social and economic arrangements as well as political and civil rights play a critical role in facilitating and reinforcing growth strategies.¹⁵⁵

Estimates suggest that investment in African infrastructure needs to be at 5% of GDP per year, plus an additional 4% for operation and maintenance. Currently, total expenditure on additional investment in infrastructure averages 2.5% and private investment a mere 0.3% of GDP. Some estimate that this is a mere 40% of the total region's infrastructure investment need.

Endeavors to attain the MDGs imply that an enabling environment is created for the productive sector to correct the balance between the social and productive sectors. The

¹⁵⁴ Calderón, C. Servén, L. 2004. The effects of infrastructure development on growth and income distribution. Central Bank of Chile. Working Papers No., 270.

¹⁵⁵ Sen, A. 1999. Development as freedom. Oxford University Press. Cambridge.

objective of this report is to confront the single complexity of economic infrastructure thoroughly and in an illuminating manner. The starting point is to focus on a country's specific strategy that identifies binding constraints that serve as impediments to accelerating growth and whose elimination will enhance the long term growth frontier of regional partners.

5.1.1 The case study on Kenya

The case study on Kenya, within the context of the East African region, was selected on the basis of the region's developing role in the continent's broader economic trajectory. Kenya represents a significant regional growth node that has the potential to unlock a diverse range of economic opportunities for neighbouring countries. The intention of the analysis is to elicit and then aggregate local information in a manner that highlights infrastructure investment opportunities that have the greatest potential of enhancing productivity as well as boosting economic and social development.

As is the case in most African countries, agriculture is the largest sector in Kenya as well as the biggest employer. Together with forestry and fishing, agriculture contributes Kshs3 out of every Kshs10 produced (Figure 1). In 2007, the agriculture sector grew by a sluggish 2.3%, down from 4.4% in 2006, because of delayed rains and a shortfall of rain during 2007's short rainy season. As a result, maize production declined by 6.1% in 2007, compared to the previous year, to 32.5 million bags. Kenya's largest export, tea, increased by 19% to 369 600 tonnes, while the other major agricultural export, horticulture, reported a whopping increase of 51.3% in export revenue.

The most notable performance in the transport sector was that of railway freight traffic, which increased by a remarkable 21.8%, compared to 2006 of 2.3 million tonnes. This significant increase in rail freight reflects the initial improvements by the new private operator of Kenya's (and Uganda's) railways, Rift Valley Railways (RVR) consortium, which was concessioned in the year 2005. This is expected to alleviate the pressure of freight traffic on Kenya's roads. The government plans to concurrently rehabilitate all major roads that lead to major border posts through a US\$43.5 million allotment.

Kenya seeks to position itself as the information and communications technology hub of East Africa and its multilateral partners are supporting this objective through funding. The World Bank extended a loan of US\$114.4 million to Kenya in 2007 as part of a Regional Communications Infrastructure Programme aimed at developing high-speed connectivity. This is expected to reduce the cost and increase the penetration of Internet connections, improve productivity and thereby support the authorities' efforts to position Kenya as an outsourcing and call centre destination.

The Kenyan government continues to tempt investors with attractive incentives to further grow the information and communication technology (ICT) industry. The government has reduced income tax for expatriates and key national employees, as well as corporate tax holidays for business process outsourcing (BPO) firms and firms offering IT-enabled services (ITES).¹⁵⁶ There are also exemptions on customs duties for ICT equipment and VAT exemptions for the local purchase of key inputs. For BPO providers, the Ministry of Information and Communications offers simplified recruitment, expedited business set-ups, and training program subsidies. Discounts on rent in BPO-specific locations are also available, and the latest technologies continually sought.¹⁵⁷

The government of Kenya plans to build an information and communication technology (ICT) city at Malili in Machakos County.¹⁵⁸ The project, which is part of the government's vision 2030 pillars of development, is to be undertaken in conjunction with the World Bank and the private sector at an estimated cost of US\$ 10 billion. The Malili technopolis is slated to become Kenya's ICT hub, hosting several ICT companies including Business Process Outsourcing (BPO), software development firms, data centres, disaster recovery centres, call centres and ICT light assembly industries. Malili was chosen as suitable site due its closeness to the city, yet being outside the city and being a driving distance of the airport. Being a non populated area, the site would be

¹⁵⁶ China Daily (2010-05-03). Major ICT initiatives connect Kenya to the world.

¹⁵⁷ Ibid

¹⁵⁸ CIO (2010-07-29): Government updates Private Sector on ICT sector, Malili. East Africa, Business Technology Leadership.

perfect for building a green city as it would present no legacy problems. More than eight universities are also expected to set up a base in the area.¹⁵⁹

Hotels and industry, a proxy for tourism, may be Kenya's smallest sector but it was the fastest growing in 2007, when it expanded by 16.3%. According to the local statistical authority, tourism earnings increased by 16.4% in 2007 to an estimated Kshs65.4 bn. In 2007, the volume of international arrivals increased by 13.5% to 1 816 800 and the number of bed nights occupied rose by 17.2% to 6 939 400.

Game parks and reserves received 2 363 800 visitors in 2007, which is a 4.2% increase on the previous year. Business tourism also performed well as is evident from the 12% and 19.2% increase in the number of international and local conferences respectively held in 2007.

The value adding sector, manufacturing, grew by 6.2% in 2007 on account of sound growth in regional demand for manufactured goods and investment in the sector. Manufactured exports are Kenya's third largest source of export revenue, after tea and horticulture. The manufactured products that perform strongly are that of food, beverages and tobacco, petroleum and other chemicals.

Kenya's coastal location makes it an important conduit for trade, especially for those involved in the commerce industry domestically and regionally. Commerce is one of Kenya's fastest growing industries, registering double digit growth in recent years. The commerce sector grew by 11.5% in 2007, similar to its 2006 growth rate, demonstrating the buoyancy of a sector that has regional importance.

The building and construction industry has grown soundly in recent years, as reflected by the significant increase in domestic consumption of cement by 16.7% to 2.06 million tonnes in 2007. The government's infrastructure investment drive has also added to this sector's increased activity. It has pledged to spend US\$1 billion on the rehabilitation and construction of its road network. Specifically, the disbursement of funds by the Kenya Roads Board to various roads agencies surged by 49.5%, compared to the previous year,

¹⁵⁹ Ibid

to Kshs15.4 billion in 2007. Furthermore, the government's expenditure on roads index increased by 67.9 percentage points to 269.0 points in 2007.

China is supporting government's initiative by financing a US\$30 million road construction project to improve the roads in the congested capital city, Nairobi. Evidently, public works programmes were a significant driver of the building and construction sector's 6.9% growth in 2007. The estimated cost of reported new buildings increased more than twofold in 2007 to Kshs5.9 million, implying that private sector involvement in the building and construction of commercial property is vibrant.

The utilities sector (electricity and water) reported strong growth of 9.2% in 2007, after a contraction in 2006. The improvement in performance reflects higher generation of hydroelectricity in 2007 on account of better rains that raised dam levels, following the 2005/06 drought. Kenya presently produces 1 060 megawatts (MW) of electricity and peak demand is 975MW. With demand estimated to be growing at 200MW per annum, full capacity is a hair's breadth away. Given the regional shortfall of electricity due to natural causes, including droughts as was the case in 2005/06, and investment in energy infrastructure that is outpaced by economic growth, Kenya together with its donor partners is investing significantly in additional energy infrastructure and attempting to diversify away from hydro and thermal power.

Last year, the Japanese government lent US\$46.4 million to the Kenya Electricity Generating company (KenGen), which supplies 80% of the country's electricity, for a new hydroelectric plant on top of the earlier investment it made for a similar facility that was scheduled to begin operating in November 2007. A subsidiary of the Chinese national power utility is financing geothermal power plants to reduce reliance on weather dependent hydropower and the impact of high oil prices on thermal powered stations. Although Kenya's relatively independent and robust private sector is in a better position to weather, the aftermath of political turmoil than that of its neighbours, the global context in which the crisis occurred has exacerbated its dampening effect on the economy and added fuel to inflation. A slowing global economy, credit squeeze in advanced economies, surging oil price and global food shortfall has compounded Kenya's politically instigated domestic upheaval. As such, we have downwardly revised Kenya's

growth projection for 2008 to 3.2%, from 7% in 2007 (Figure 2). The economy is expected to recover over the medium term, barring any mishaps, and grow by a respectable 4.8% in 2009. We only expect a return to growth rates in excess of 6% in 2012.

The government has pledged to spend US\$1 billion on the rehabilitation and construction of its road network. In 2007, Kenya Roads Board disbursement to various roads agencies increased by 49.5%, compared to 2006, to Kshs15.4 billion.

Kenya's location implies that the transport, storage, communication and commerce sectors are intrinsic activities. This explains the importance of transport infrastructure development to the development of other sectors of the economy, including agriculture, manufacturing, energy and tourism. Investment in Kenya's transport infrastructure and its linkages to that of neighbouring countries is expected to facilitate regional integration and investment, trade and economic advancement.

Kenya's growth potential is being constrained by inadequate infrastructure. Transport infrastructure, in particular, has suffered from years of underinvestment. The snail's pace of the railway system implies that roads are the preferred mode of transport for passengers and freight. Heavy pressure on the roads has resulted in considerable wear and tear, high accident rates and an inflated cost of transportation. Kenya's coastal location implies that its neighbouring countries import and export a fair share of their goods through the Mombasa port. The capacity and efficiency of the port hence has implications on regional trade (See table 2 below).

Table 2: Comparative infrastructure indicators

| INDICATORS | Kenya | Sub Saharan Africa (average) | Low income countries | OECD (average) |
|--|--------------|-------------------------------------|-----------------------------|-----------------------|
| GNI per capita, Atlas method* (current USD) | 580 | 1,454 | 487 | 33,470 |
| Access to electricity (% of population) | 8 | 27 | 28 | |
| Electric power consumption (KWH per capita) | 120 | 719 | 631 | 8,769 |
| Improved water source (% of population with access) | 61 | 65 | 64 | 99 |
| Improved sanitation facilities (% of population with access) | 43 | 37 | 38 | 0 |
| Total telephone subscribers per 100 inhabitants | 14 | 19 | 9 | 0 |

Source: The World Bank Group and the Public Private Infrastructure Advisory Facility.

The proportion of Kenyans with access to electricity and consumption per capita is low relative to the region and other low income countries and this is aggravated by the countries' dependence on unreliable weather for most of their electricity. Recurrent droughts impact the generation of electricity, particularly as a sizeable share of power is generated through hydroelectric power stations.

Public sector investment in roads, in particular, has compensated for the underinvestment by the private sector. In the 2007/08 (July – June) budget, the government's allocation to roads was almost eightfold that of energy. This concentration of the government's development expenditure on road infrastructure illustrates the dire need to rehabilitate Kenya's road infrastructure. Aside from roads, other transport subsectors, including railroads and sea ports, also require significant upgrading and in some instances,

expansion. As the health of Kenya's transport infrastructure is critical to regional transportation and trade, attracting investment into it should be a top priority.

5.1.2 Challenges of Kenya's transport infrastructure in a regional context

The significant expansion of tourism in the three year period preceding the December 2007 elections also spurred a considerable increase in passenger transport that has added to existing demands on transport infrastructure, including freight transport. Reversing the transport infrastructure deficit is a long term challenge; however, the government's prioritization of infrastructure spending coupled with assistance from development agencies. Most notably, the World Bank is expected to make significant contribution by funding projects intended to increase the quantity and quality of transport infrastructure.

Kenya's main modes of transport include road, rail, air and sea. Road haulage is projected to continue growing strongly and outdo the growth in GDP; however, congestion is expected to constrain its growth.¹⁶⁰ The rate of expansion of rail freight is expected to be moderate and outdone by GDP growth. However, the new concessionaire is expected to spur an acceleration of its growth rate over the medium term.¹⁶¹ Maritime freight handling has been on a recovery path since its slump in 2005 and greater growth potential is expected to be realized over the next few years. Total freight traffic is projected to increase by 8.1% annually over the medium term. The transport and communication sector, which in recent years has outpaced GDP growth, is projected to increase in value to USD3.94 billion in nominal terms and constitute 8.1% of GDP (BMI, 2008). The sector is estimated to have employed 94 000 people in 2007, which is 5% of the labour force, and is projected to increase to 104 000 by 2011, as the sector's labour force expands at the same rate as the country's.¹⁶²

As the linkages of Kenya's modes of transport and their connectivity to the region's transport infrastructure, particularly the landlocked countries, is important for the development of the East African region. An assessment of the Northern Corridor (also referred to as the Mombasa corridor), which constitutes transit and interstate transport

¹⁶⁰ Business Monitor International (2008). Kenya Freight Transport Report 2008.

¹⁶¹ Business Monitor International Ltd (2008). The Kenya Business Forecast Report, Q2 2008.

¹⁶² *ibid.*

infrastructure, facilities and services in East and Central Africa that are linked to the Mombasa port, is more effective than looking at each transport subsector in isolation. The Northern Corridor links the port on the east coast of Kenya to the neighbouring countries, namely Uganda, Rwanda, Burundi and the Democratic Republic of Congo. All five countries are signatories to the Northern Corridor Transit Agreement, whose main objective is to support the fluid movement of trade and traffic across the region. The Northern Corridor, which is also linked to Northern Tanzania, Southern Sudan and Ethiopia, is in dire need of an improvement in transit facilitation. In particular, current customs procedures, documentation and controls are tedious and burdensome and inhibit the free flow of goods and persons. The delays caused by complex cargo clearance procedures add to high transportation costs as a result of long transit and turnaround times for transport equipment.

The Northern Corridor's transit costs are estimated to be two to three times greater than those of the world's developed regions (Transport Transit Coordination Authority of the Northern Corridor TTCANC). Transport costs constitute 35-40% of the value of the landlocked countries' imports. The competitiveness of exports from the region destined for overseas markets is also undermined by the high cost of transporting them to the ports of exit. The transformation of the Northern Corridor to a development corridor in 2003 allowed for synergies to be created between the region's transport infrastructure development initiatives and the development of other sectors of the economy.

An improvement in the efficiency of transport logistics that translates into lower transport costs would advance the competitiveness of exports and reduce the cost of imports, which would ease the cost burden of manufacturers that import some of their inputs. According to a 2003 study by Consilium Legis (Pty) Ltd on East and Southern Africa's transport networks, Kenya, in 2003, had achieved the critical mass required to enable continued implementation of reforms in the transport sector but its policy framework for its transport corridors remained inadequate and the draft legislation and regulatory frameworks were still being prepared. With regard to progress in reforming various aspects of transport infrastructure and institutions, Kenya had made the greatest progress in reforming road transport and reported satisfactory progress in advancing corridor

institutional development. There had been modest improvement in road infrastructure and the easing of the burden of traffic on roads. However, little progress had been made in reforming railways, maritime transport and inland waterways, and no advancement had been made in transit facilitation.

The New Partnership for Africa's Development (NEPAD) has prioritized transit facilitation for the Mombasa corridor that is expected to enable border post reforms, such as the introduction of joint controls that may include one stop border post operations. Border posts that were proposed for one stop border posts, earlier this decade by the East Africa Community included Malaba (Kenya/Uganda border), the Northern Corridor's busiest border post, and Busia (Kenya/Uganda border). To this end the railway building in Malaba was refurbished to house Kenya and Uganda's respective revenue authorities, customs and other transit transport facilitation authorities that clear railway cargo passing between the two countries.

Kenya has one of the region's most extensive road networks with about 153 000km of highways and about 80% of all freight is transported by road (BMI, 2008). Kenya also has one of the highest densities of roads in the region, with 0.11 km of road per square kilometer but trails behind South Africa's 0.3 km and Zimbabwe's 0.25 km (African Development Bank ADB). An estimated 15% of Kenya's roads are bitumen paved, 42% have gravel surfaces and the remainders are earth tracks (BMI, 2008). Heavy usage of roads, including overloading of vehicles has amplified congestion, particularly in Nairobi and accelerated the deterioration of roads.

In recent years, Kenya has made modest gains in improving road infrastructure and in easing of the burden of traffic on roads. Little progress had been made in reforming railways, maritime transport, and inland waterways. To add verve to road reforms, Kenya requires the legal framework to authorize levying and collection of harmonized road transit charges. To reduce road traffic and the resultant wear and tear of roads, Kenya outlawed seven axle trucks, which are reputedly notorious for damaging roads. However, the deadline was not observed by all, including the Kenya Transporters' Association, who argued that it had not been given sufficient time to adjust accordingly. A legal framework is also required to support the establishment of public private partnerships (PPPs) in

weighbridge operation and management. Kenya is in the process of developing regulatory frameworks for ports and railways, and also requires regulatory capacity building.

The Northern Corridor's main roads network totals nearly 7 000km, of which 60% is paved, and it extends from Mombasa through to Nairobi, Kampala and Kigali, and ends in Bujumbura. Eastern Democratic Republic of Congo (DRC) connects onto this network from Kigali through either Goma or Bukavu to Kisangani. The DRC is also connected to the network through Bunagana and Beni, among other towns, to Kisangani.

The heavy pressure on the region's roads is due to the Northern Corridor's limited rail network. The landlocked countries that trade through the Mombasa port, Rwanda, Burundi, eastern DRC and southern Sudan are not connected to the East African railway system. Thus, as freight traffic has increased over recent years, the burden has increasingly been borne by road infrastructure (Table 8). In the five year period to 2003, the Northern Corridor's roads' share of road and rail traffic rose from 51% to 73%.

The Kenyan section of the Northern Corridor railway is a single track railway system that runs from Mombasa through Nairobi to the Ugandan border and is owned by the government parastatals, Kenya Railways Corporation (KRC). The KRC has about 150 locomotives for the main line, branch line and shunting duties.¹⁶³ It has a carrying capacity of 6 407 wagons. The rolling stock operates along the track and 150 stations that link the main centres of Mombasa with Malaba, Nakuru with Kisumu, Kisumu with Butere, Voi with Taveta, Nairobi with Nanyuki, Eldoret with Kitale, Rongai with Solai and Gilgil with Nyahururu. A sizeable share of the freight traffic on the railway system is to regional countries. Commodities that are transported on the line include cement, coffee, soda ash, sugar, salt, fluorspar, petroleum products, grains, and paper, timber and dairy products.¹⁶⁴ The KRC also has containers that are handled through cargo trains which operate daily between the Mombasa port and Nairobi's container depot at Embakasi.

¹⁶³ Business Monitor International Ltd (2008). The Kenya Business Forecast Report, Q2 2008.

¹⁶⁴ Ibid

Kenya and Uganda concessioned their railways to RVR for 25 years after the passage of legislation that enabled market liberalization in the ports and railway sector. This is a vertically integrated concession. In addition to operating trains, RVR is also responsible for track maintenance. The private concessioning of the Kenya-Uganda railway is expected to transform the railway that runs from the Mombasa port in Kenya to Kampala, the Ugandan capital, into a major efficient transport conduit for the region. By mid 2007, rail traffic had increased and accidents had dropped to about 10 a month from 65 previously. Despite these developments, substantive improvements in the railway were only expected to show in 2010. The USD32 million loans that RVR received from the International Financial Corporation (IFC) in December 2006 is expected to support the RVR's mandate of rehabilitating the railway system and infrastructure. RVR's priority is to improve safety by enforcing speed and weight limits.¹⁶⁵ This is expected to increase capacity and improve turnaround times.

A large share of East Africa's overseas trade passes through the biggest port in East and Central Africa, Mombasa, and as such, congestion at the port has regional repercussions because of its importance to trade. A study by Kenya Ports Authority (KPA) in 2007 on government parastatals that manages the Mombasa port revealed that containers destined for Kenya and for Uganda were the greatest contributors to the congestion problem. Transit transport has increasingly contributed to traffic at the port. Between 1999 and 2003, transit goods increased from 1.31 million tonnes to 2.45 million tonnes. Transshipment traffic increased by more than fourfold over the same period to 610 000 tonnes.

Multilateral financial institutions and donors have played a significant role in addressing Kenya's infrastructure deficit. From a regional perspective, the European Union (EU) is the dominant financier of transport corridors in the Southern African Development Community (SADC) region (excludes Kenya) and has contributed to a sizeable share of financing through its regional financing programme (Consilium Legis (Pty) Ltd). USAID is also a big financier in the SADC region but has not committed as much as the EU. Of

¹⁶⁵ Business Monitor International Ltd (2008). The Kenya Business Forecast Report, Q2 2008.

more relevance to Kenya is the fact that the EU and the World Bank are the largest financiers in the EAC and the Common Market for Eastern and Southern Africa (COMESA).

The EU shifted its focus from financing predominantly infrastructure projects to soft issues (i.e. the creation of enabling environments for growth and institutions) earlier this decade. Similarly, the World Bank has also largely concentrated on infrastructure rehabilitation, roads, ports and railway sector reforms, trade facilitation and HIV/Aids control; however, it also recently sought a change in focus toward softer issues that include database development, border post reform and corridor institution building. Conversely, USAID has traditionally concentrated on the facilitation of soft barriers, such as border post reforms and corridor institution building.

It is important to note that one large financier does not fund or monopolize the development of an entire corridor. There are gaps in financier programmes that require the participation of other financial backers. Financier consortia arrangements have developed a system that involve public (regional) – private (foreign) and private (regional) – private (foreign) partnerships, that in essence create a financier platform where sponsors can collectively plan, assign priority assistance and monitor implementation. The Sub-Saharan Africa Transport Policy (SSATP) programme is one such initiative. The SSATP is a partnership of 35 African countries, eight regional economic communities, three African institutions (United Nations Economic Commission for Africa (ECA), the African Union/NEPAD, national and regional organizations and international development partners. It is funded by the European Commission, Denmark, France, Ireland, Norway, Sweden, the United Kingdom, the Islamic Development Bank and the World Bank.¹⁶⁶

Northern Corridor Dominant financiers EU (transit facilitation/road infrastructure)
Official Development Assistance/United Nations Development Programme (transit facilitation)
USAID (transport costing ; trade facilitation ; customs fraud and cargo

¹⁶⁶ Business Monitor International Ltd (2008). The Kenya Business Forecast Report, Q2 2008

diversion) World Bank/International Finance Corporation (roads infrastructure/ports and railway reform) Mombasa – Kampala – Kigali – Bujumbura Corridor.

The bulk of non private financiers' involvement in Kenya's transport infrastructure prior to mid 2003 had been directed towards road rehabilitation. Conversely, in absolute numbers; private participation has been dominant in Kenya's railroads, specifically the railway concession. Evidently financiers preferred transport infrastructure projects differ according to their objective. While the public sector and donor agencies have a developmental agenda, the private sector is seeking an attractive return for its investment. As transport infrastructure tends to be a public good as well as natural monopoly, given the size of sunk costs and existence of economies of scale and scope, the partnering of the public sector, which owns the infrastructure, and a private participant that operates it under competitive conditions is an attractive approach for infrastructure development.

The development corridor approach employs the spatial development initiative concept that acknowledges the interdependence of various sectors of an economy and positions transport infrastructure development as a facilitator of social and economic development. The subsequent improvement in the operating environment would be conducive for the promotion of PPPs, particularly in major infrastructure projects. This is expected to reduce the dependence on official development aid and encourage private sector participation in significant development projects.¹⁶⁷

5.2 Nairobi – Thika Highway Improvement Project.

The Kenya Vision 2030 recognizes the importance of development of infrastructure as critical for socio-economic transformation. The Infrastructure Sector aspires for a country with modern metropolitan cities, municipalities and towns with infrastructural facilities that meet international standards to make Kenya a globally competitive and prosperous country. The strategies and measures to be pursued in the medium term include; supporting the development of infrastructure initiatives around flagship projects, strengthening the institutional framework for infrastructure development, raising the efficiency and quality of infrastructure as well as increasing the pace of infrastructure

¹⁶⁷ Business Monitor International Ltd (2008). The Kenya Business Forecast Report, Q2 2008

projects so that they are completed as envisaged, protecting the environment as a national asset and conserving it for the benefit of the future generations and the wider international community. Other measures include encouraging Private Sector participation in the provision of infrastructure services through the Public-Private-Partnerships (PPPs) framework.

The Government of Kenya (GOK) has solicited the financial assistance of the Bank for the rehabilitation and upgrading of the Nairobi-Thika highway. The Nairobi-Thika road is a dual carriageway highway of about 45 km. The road is part of the classified international trunk road A2 which originates in downtown Nairobi and extends to Moyale at the Ethiopian border. The section of highway under consideration was constructed to bitumen standard in the early 1970's. This section currently operates beyond capacity, carrying more than 30,000 vehicles per day. In addition, its condition has deteriorated requiring rehabilitation. Therefore to accommodate the existing and future traffic, the highway needs substantial improvements to increase its capacity which will entail the construction of additional lanes and the removal of intersections at six locations to be replaced by interchanges. Three Chinese companies are building a 31-mile road from the Kenyan capital of Nairobi to the town of Thika. The three Chinese companies include; The China Wu Yi (Kenya) Corporation, Sheng Li Construction Company and Sinohydro Company.

5.2.1 Project Justification and Objectives

The objective of the project is to improve road transport services along the Nairobi-Thika corridor by reducing traffic congestion and enhancing mobility within the metropolitan area through better linkages to the immediate and distant suburbs. The Nairobi-Thika road is characterized by heavy traffic that is increasing with time as a result of the rising urban population along the route. The poor physical condition of the road and its limited capacity are associated with significant travel delays, high fuel consumption, high vehicle emissions as well as social inconveniences. The proposed expansion and rehabilitation of Nairobi – Thika road will substantially alleviate traffic congestion within Nairobi City, and between the city and the satellite town of Thika. A large number of commuters who

work in Nairobi reside along this section of the project road. In addition, main centers' along the road, namely Kasarani, Githurai, Ruiru, and Juja, are burgeoning industrial and commercial centres.¹⁶⁸

5.2.2 Project Concept and Description

The scope of project includes the following components:¹⁶⁹

5.2.2.1 Nairobi –Thika Highway Upgrading Works:

This component involves: (i) The provision of additional capacity through construction of additional lanes (from four-lane to a six/eight lane highway), and reconstruction of the existing carriageway pavement; (ii) the construction of services roads to segregate through traffic from local traffic; (iii) the construction of traffic interchanges at six (6) locations to replace the existing roundabouts at Pangani, Muthaiga, General Service Unit, Kasarani, Githurai, and Eastern Bypass; and (iv) The rehabilitation of some existing bridges, execution of drainage structures, road safety devices, and environmental mitigation measures.

5.2.2.2 Project Feasibility and Detailed Engineering Design for Nairobi Public Transportation System.

This component is a follow-up to the Nairobi Urban Transport Master Plan study funded by JICA. This component will focus on public transportation system. A comprehensive public transportation study will be undertaken. The study will include an economic feasibility, environmental and social impact assessment (ESIA), financial and institutional arrangements for various options including Light Rail Transit System, Bus Rapid Transit System, Enhanced Commuter Rail, etc. Detailed engineering design and

¹⁶⁸ African Development Fund (2007). Nairobi-Thika Highway Improvement Project. Environmental & Social Impact Assessment (ESIA) summary

¹⁶⁹ Ibid

tender documents will be prepared for the most viable options to address the immediate and short term public transportation needs.¹⁷⁰

5.2.2.3 Private Sector Participation in the Nairobi-Thika Highway Project

Under this consultancy component, the consultant will conduct alternative financial and institutional analyses for the proper management, operation and maintenance of the Nairobi-Thika

Highway. The consultant will be responsible for preparing the necessary bidding and contractual documents and advising the government in the transaction process.¹⁷¹

5.2.2.4 Project Technical and Financial Audits:

An independent external financial auditor and an Independent Engineering/Construction Auditor shall be selected to provide project audit services. The purpose of the financial audit will be to ensure that the proceeds of the loan are used economically, efficiently and solely for the purpose for which they are intended. The purpose of the technical audit is to ensure that the contractor and consultant are performing according to specifications.

5.2.2.5 Compensation and Resettlement of Project Affected People

This component makes provision for the adequate compensation and resettlement of Project Affected People identified in the Project Environmental and Social Impact Assessment.

5.2.3 Policy, Legal and Administrative Framework

The Government of Kenya's Policy on Road Transport is to provide efficient and reliable road network to spur social, economic and security improvement. Kenya's National Environment Action Plan process culminated in the formulation of the policy on Environment and Development under Sessional Paper No. 6 of 1999. This policy

¹⁷⁰ African Development Fund (2007). Nairobi-Thika Highway Improvement Project. Environmental & Social Impact Assessment (ESIA) summary

¹⁷¹ *ibid*

presents broad categories of development issues that require a sustainable approach. Its main objectives are to ensure that: all development policies, programmes and projects take environmental considerations into account from the onset; an independent Environmental Impact Assessment (EIA) report is prepared for any project or development before implementation.

The key environmental assessment and monitoring agencies in the Road Sector include National Environmental Management Authority and Provincial and District Environment Officers. The key legal instruments applicable to environmental and social management with respect to this road project are Environmental Management and Coordination Act (EMCA, 1999); Environmental Impact (Assessment and Audit) Regulations, 2003; Environmental Management and Co-ordination (Waste Management) Regulations 2006; Environmental Management and Coordination (Water Quality) Regulations 2006; Factories and Other Places of Work Act, Cap 514; Factories (Building Operations and Works of Engineering Construction) Rules 1984; Factories and Other Places of Work (Fire Risk Reduction) Rules 2006 (Draft); Water Act, 2002; Public Health Act, Cap 242; Way leaves Act, Cap 292; Land Acquisition Act, Cap 295; Public Roads and Roads of Access Act, Cap 399 and Limitations of Actions Act Cap 22.¹⁷²

5.2.4 Social/ Economic Setting

The main catchment area of the project has an estimated population 843,526 comprising 446,930 male and 397,019 female and a total of 252,330 households (1999 Population Census Projections). The population growth rates are estimated at 2.68% with relatively high population densities averaging 660 persons per square km in Kiambu and 358 persons in Thika.¹⁷³ The two districts have significant urban populations which determine the type of activities and characteristics. Kiambu has 69% urban and Thika 34% of the populations. Poverty is a major concern with 25% and 48% of the populations living below the poverty lines in the two districts, respectively (Kiambu and Thika). Unemployment is rampant especially in Thika which stood (2002) at 34%. Kiambu being very close to Nairobi city is classified as a residential area of people on

¹⁷² NEMA Draft EIA Guidelines, November 2002.

¹⁷³ Thika District Development Plan 2002 – 2008

wage employment (64% of households) hence its unemployment rate is relatively low, at 8%.¹⁷⁴ The main economic activities and features along the route are human settlement structures with some farming activities but with significant urban characteristics. There are well over 50,000 primary sub-plots along the project road. The area is characterized with mixed land use patterns which include residential plots and business premises such as petrol stations, commercial premises, shops, catering, stores and educational institutions. Extraction of building stones from quarries in Juja is quite vivid. There is a thriving informal sector (Jua kali) specializing in metal work, carpentry, vehicle repairs, dressmaking and construction.

Other notable land uses include farming (in food and cash crops) as well as livestock keeping for meat and dairy. Road side traders are also a common feature in fodder, vegetables, Napier grass, tomatoes, maize, beans, tree nurseries and other farm products. Some commercial agriculture also takes place in the road corridor such as horticulture flower growing and coffee farming.

The social wellbeing of the people in the project area is characterized by relatively high primary school education performance with a net enrolment rate of 83% in Thika and 89% in Kiambu. In both cases, girls match up with boys. Secondary enrolment is also above average for most Sub-Saharan African countries averaging 61% in Thika and 50% for Kiambu. The main health problems in the area are malaria, respiratory tract infections, bronchitis and HIV/AIDS related diseases. While these are within national average HIV/ADS prevalence rates (6.4%, 2005), the impact on women is far much higher than that for men especially in Thika where prevalence among women is 9.5% compared to men at 2.5%. Availability of potable water varies between those in unplanned slums and those connected to the water articulation systems. Distances walked to water sources average between 0.5 km in Thika and 2.3 km in Kiambu. Usage of pit latrines is relatively high with 79% of households in Thika and 88% in Kiambu.

¹⁷⁴ Kiambu District Development Plan 2002 – 2008

5.2.5 Potential Impacts and Mitigation/Enhancement Measures

The major positive environmental and social impacts anticipated as a result of the project were: The reduction of “on-the-spot” vehicular aerial emissions emitted by stationary vehicles during traffic jams, especially during the rush hour; reduced road accidents, particularly of heavy trucks, which reduces the number of injuries and fatalities, as well as the risk of pollution of soil and water sources from spills; reduced congestion along the entire project route, resulting in time savings and resultantly in increased productivity and less stress to road users, and even attracting more people to live in the peri-urban areas.¹⁷⁵

The road project comprises the rehabilitation of an existing road. No major realignments are proposed, while any improvements to curvature and sight distance will be accommodated within the road reserve. Thus, the direct impact on land use is negligible, and the requirements for land acquisition are minimal.¹⁷⁶

¹⁷⁵ NEMA Draft EIA Guidelines, November 2002.

¹⁷⁶ African Development Fund (2007). Nairobi-Thika Highway Improvement Project. Environmental & Social Impact Assessment (ESIA) summary

CHAPTER SIX

BUSINESS RELATIONS BETWEEN KENYA AND CHINA AND ITS ECONOMIC IMPACT IN KENYA (2008-2011)

6.0 Introduction

This chapter entails a discussion of the findings of the study whose aim was to determine the economic impact of international business relations between Kenya and China through construction of Nairobi-Thika highway by Chinese contractors. The study targeted the economic relationship between Kenya and China in a five –year period from 2008 to 2011 during which construction of Nairobi-Thika highway took place. The study looked into different strategies used by government ministries in Kenya to strengthen international business relation and the economic benefits associated with the construction of Nairobi-Thika Highway.

6.1 The role of government ministries in promoting international business relations

6.1.1 Ministry of Trade.

The Ministry of Trade has an important role in promoting international business relations. The Ministry of Trade is responsible for the promotion of trade domestically, regionally and internationally through creation of an enabling business and investment environment. Trade Sector plays a crucial role towards attainment of national development objectives particularly as envisaged in the Vision 2030 and in addition, realization of the Millennium Development Goals (MDGs) one and eight on eradication of extreme poverty and developing global partnership for development through improved market access respectively.

The Ministry of Trade has been mandated to execute the following functions that enhance trade: the Ministry formulates and implements policies that govern trade development; promotion of retail and wholesale markets, development of micro and small

business; implementation of fair trade practices and consumer protection; private sector development and participation in international trade affairs. Moreover, the Ministry of Trade is guided by the following core values in order to achieve development in both local and international trade: the Ministry values efficiency in communication which ensures that there is smooth information flow for both internal and external stakeholders; the Ministry encourages integrity and transparency which ensures that there is accountability and devoid the Ministry of corrupt practices in service delivery; the Ministry upholds people centered services and customer satisfaction by ensuring that customers are treated with courtesy and respect and delight in their satisfaction; there is commitment of all official time to the duties within the Ministry and customers are dealt with without unnecessary delays; development of team work by encouraging team spirit, collaboration and consultation as a way to maximize the synergy of working together for improved service delivery; encouraging innovativeness and creativity by being open and proactive in seeking better and more efficient methods of service delivery.

6.1.1.1 Policy Priorities within the Ministry of Trade

The policy priorities within the Ministry of Trade are based on the pillars of trade and investment. For the Ministry of Trade to promote international and local trade, the aspects of trade have been prioritized are as follows: expansion and diversification of domestic and export trade, enhancement of support for trade facilitation, promotion of e-trade, expansion and strengthening of public private partnership, establishment of a trade and investment information sharing system, provision of entrepreneurial skills for entrepreneurs, support of the improvement of business and investment climate, formulation of appropriate trade remedy regime, development of an appropriate negotiating structure, development of an integrated data base on trade in goods and services and aggressive promotion of trade in services. The investment priorities include: improvement of investment and business climate, promotion and facilitation of investment in the trade sector by international and local business organizations, enhancing support for business research and development and facilitating access to venture capital for local traders.

6.1.2 Ministry of Foreign Affairs

The study sought to find out strategies used by Ministry of Foreign Affairs to attract foreign investment in Kenya. The study established that different individuals, institutions and organizations participate in the foreign policy formulation and decision-making. From this perspective, the Ministry of Foreign Affairs is only a facilitator, coordinator and a steward of the country's foreign policy; the various government agencies are complementary actors in the conduct of foreign policy. In order to attract foreign investment, the Ministry of Foreign Affairs has adopted strategies such as launching a private sector delivery partner with the incentive to attract and retain high-value investments; expanding the Global Entrepreneur Programme (GEP) to gain more investment to the UK; bringing more private sector expertise into its relationship with exporters and inward investors; developing partnerships with key businesses which support small and medium enterprises (SMEs); using different networks to raise awareness of the benefits of exporting and creating a new online self-help community for UK SME exporters to support each other and share experience as they seek to internationalize their businesses.

6.1.3 Ministry of Roads and Ministry of Public Works

The Ministry of Roads and Ministry of Public Works are very much involved in infrastructure development in Kenya. The two Ministries were one Ministry until 2008 when they were separated for political reasons but they share much in common. The Ministry of Roads is mandated to rehabilitate and maintain Roads while the Ministry of Public Works is mandated to maintain and rehabilitate government buildings as core. The Ministry of Public Works is also mandated to facilitate provision and maintenance of buildings and other public works in the country. Both Ministries have the following responsibilities in development of infrastructure: formulation of public works policy; planning of public works; development and maintenance of public buildings; maintenance of inventory of government property; provision of mechanical and electrical (building) services; co-ordination of procurement of common user items by government ministries; registration of architects and quantity surveyors; registration and regulation of

contractors; consultants for buildings and civil works and materials suppliers; registration and regulation of Civil, building and electromechanical contractors.

The two Ministries employ several strategies in development of infrastructure in Kenya. The following provisions are in the Service Charter of the Ministry of Public Works which ensures that the Ministry of Roads and Ministry of Public Works achieves their mandates in development of infrastructure in Kenya. The two twin ministries promises to: provide prompt, complete and accurate information on all enquiries, show courtesy and respect while dealing with clients, ensure privacy and confidentiality in their dealings with clients. The two upholds the following core values in the effort to ensure efficient service delivery: diligence and selflessness, respect and courtesy, continuous improvement, professionalism, efficient and responsible use of resources, open, proactive, impartiality and honesty.

The two Ministries have several strategies which ensure that they remain committed to both local and international clients. To the clients dealing with buildings, the Ministry of Public Works avails designs for public buildings, submit bills of quantities, source for tenders, issue final accounts on contracts and respond to emergencies immediately. To other public works, the ministry facilitates construction of sea walls and break waters to protect the land from sea wave action, facilitate transport on water (sea and lakes) by construction of jetties, improve communication in human settlements through construction of footbridges and provide necessary technical advice on rehabilitation and maintenance of seawalls and jetties. With respect to payments, the two ministries prepares interim payment certificate to Roads and building contractors at no cost and pay for goods supplied and services rendered at no cost. Exclusively too, the Ministry Roads ensures that the materials used for construction of Roads are well tested at Materials Department to meet the international standards. Currently, the Ministry of Roads has been restructured and three authorities formed namely: Kenya National Highways Authority (KENHA), Kenya Urban Roads Authority (KURA) and Kenya Rural Roads Authority (KERRA). The Ministry too has an oversight body known as the Kenya Roads Board (KRB) which manages and monitors the use of the road maintenance fuel levy. The two Ministries also communicate the outcome of tenders to all bidders within twenty

one days from the tender closing date at no cost. In relation to complaints, all letters received are responded to within a minimum of seven days and customers visiting their offices are attended to within a period of ten minutes.

6.2 Kenya's involvement in multilateral trade agreements

The study sought to establish Kenya's involvement in multilateral trade agreements. From the findings, Kenya supports multilateralism through the United Nations system. Kenya prefers a multilateral approach in confronting problems in the international stage. Kenya fully subscribes to the charters of the United Nations and the Organization of African Union and seeks to work with like-minded states in the promotion of a new international political and economic order. This is based on a strong conviction that the multi-dimensional problems affecting mankind today have to be tackled through a global undertaking. Towards this end, Kenya continues to undertake its responsibilities in the context of UN system, World Trade Organization, IMF/World Bank and other multi-lateral bodies. Kenya is a member of the Commonwealth, a voluntary association of 54 independent states, comprising about one quarter of the world population. The primary focus for the Commonwealth is the advancement of development interests of member countries. Technical assistance to Commonwealth developing countries like Kenya is a vital component of this co-operation.

6.2.1 Treaties that promote Kenya's participation in international trade

The responsibility for concluding treaties involving the Republic of Kenya lies with the Ministry of Foreign Affairs. The Ministry is responsible for policy aspects as well as matters of form and procedure. The Ministry has a treaty section within the legal division that keeps records of bilateral and multi-lateral treaties involving Kenya. It runs an inquiry service that provides information on treaties. The Ministry also coordinates Kenya's responsibilities as depository for international treaties.

Kenya is a signatory to following Memorandums of Understanding (MOU'S): Cultural Scientific and Technological Cooperation between Kenya and Italy; Establishment of port relationship between Port Klang Authority of Malaysia and Kenya Ports Authority;

Technical cooperation in water resources management and development between Kenya and Iran; Scientific and technological cooperation between Kenya and Malaysia and cooperation in the planning and implementation of road projects between Kenya and Malaysia. Besides, there is a joint commission for bilateral cooperation between Kenya and Iran, Libya and Venezuela. Kenya has also signed agreements on trade and protection of investments for instance, agreement on promotion and reciprocal protection of investments between Kenya and the Swiss Confederation, agreement on proposed investment projects by Libya, agreement on promotion guarantee and protection of investments between Kenya and Libya, an agreement on debt-for- development swap between Kenya and Italy and cultural agreement between Kenya and Venezuela.

6.3 Kenya-China Economic and Trade Cooperation

The Ministry of Trade signed a Memorandum of Understanding (MOU) with Ministry of Commerce of People's Republic of China in June 2007, aimed at strengthening bilateral economic and trade cooperation between the two countries. This is to be achieved through enhanced information exchange, and communication and co-operation between enterprises, in particular, Small and Medium Enterprises in both countries. The MOU provides for establishment of the Kenya-China Economic and Trade Cooperation website where each country will upload information in: policies and regulations on trade and investment, macro-economic data, industry and market, business and products, exports and imports among other information.

The government of Kenya has involved Chinese contractors in construction of major roads in the country. The government of Kenya awarded the tender for rehabilitation of the Nairobi-Thika Highway covering a distance of 31 miles to three Chinese companies namely: The China Wu Yi (Kenya) Corporation, Sheng Li Construction Company and Sinohydro Company. This indicates the good business relations between Kenya and China.

The government of Kenya has taken other initiative that enhances Kenya-China Economic and Trade Cooperation. For example, the Government of Kenya participated in the trade exposition in Shanghai in China in the year 2010. The theme of the exposition

was “Better City, Better Life” which was important to Kenya’s development agenda. The exposition accorded Kenya the opportunity to join the international community in finding solutions to challenges facing mankind, particularly the challenge of environmental conservation in the context of rapid urbanization. The Government of Kenya viewed the exposition as an important cultural exchange avenue. The exposition provided an opportunity for people to build relationships through music and dance, among other activities, thereby appreciating each other’s way of life.

6.4 The Nairobi-Thika Highway Improvement Project in Kenya

The Nairobi-Thika Highway Improvement Project in Kenya was intended to achieve the following three objectives: improve road transport services along the Nairobi-Thika corridor and reduce traffic congestion; develop a sustainable urban public transit system for the Nairobi Metropolitan Area; and boost private sector participation in the development of road infrastructures. This study sought to establish the economic impact of project in Kenya and its impact on business relationship between Kenya and China. To achieve this objective the respondents were requested to provide information on the benefits of the project.

6.4.1 The benefits of the Nairobi-Thika Highway Improvement Project in Kenya

Several benefits have been associated with Nairobi-Thika Highway Improvement Project in Kenya. The benefits cited include: improved traffic flow into and out of the city; reduced numbers of accidents along the road and reduction in fuel consumption, which translates into economic savings for vehicle owner. The benefits in the economic evaluation include vehicle operating cost savings, travel time savings for passenger and cargo, and road maintenance savings.

6.4.1.1 Improved traffic flow into and out of Nairobi city

The Nairobi-Thika Highway Improvement project has enhanced traffic flow into and out of Nairobi and Thika. The project has minimized traffic congestions on busy roads serving as outlet for vehicles traveling from central business district of Nairobi. The project has also increased the smooth flow of vehicles on certain road segments and for

different situations (e.g. rush-hour or leisure time trips), has also shortened the time taken by public service vehicle to make the one trip time and fall of congestion-related emissions of gases like carbon dioxide. Improved traffic flow into and out of the city therefore boost economic activities through punctuality to offices and ease of flow of goods and services.

6.4.1.2 Savings in time which result in higher economic productivity

The Nairobi-Thika Highway Improvement project has led to savings in time which benefits businesses, organizations and employees. Savings in time allow businesses to have more accomplished in less time. Getting more done in less time increased output in different works and led to more income. Time saving improves the efficiency on certain procedures or projects within the business. Time saving gives employees a greater sense of accomplishment. By gaining a greater sense of accomplishment, employees have better self-esteem and they are happier. This increased employees' performance. When time is saved, there is more time to do the pleasant activities in a business. These more pleasant activities can boost employee morale, further employee efficiency. Generally, improved efficiency lead to time saving benefits the business and improve the profit margin.

6.4.1.3: Improved access to social and economic centers

The Nairobi-Thika Highway Improvement project has led to improved access to some social and economic centers such as markets, schools, health facilities and government offices.

The superhighway as it is popularly referred to locally has opened up the vast northern Kenya for economic development. Tourism in various national parks and game reserves has been enhanced through improved accessibility. Investors and entrepreneurs including industrialists will benefit by relocation to areas along Thika superhighway. They have easier access to the markets and space for expansion. There has been an increased investment in real estate. Speculators are also likely to make money by selling land near the superhighway or accessible from the highway. More investors are building residential

houses along the highway because of improved ease of commuting from Nairobi to towns along the highway. This allows workers in Nairobi get alternative accommodation. Building the highway has created lots of jobs for the construction workers and created lots of demands for goods and services.

6.4.1.4: Enhanced travel efficiency for commuters:

The project road has facilitated travel for commuters especially wage employees and students. A great number of households in towns along the highway rely on wage employment mainly sourced in the Nairobi CBD. Students from Nairobi and other places are able to travel with ease to the education institutions in and out of Nairobi.

6.4.1.5: Enhanced returns to commerce and agriculture:

Agricultural activities have been enhanced by the road. There are many trade and commercial operators between Nairobi and the towns along the highway. Earnings from dairy products and horticulture have increased due to the improved access to markets for inputs and produce, and enhanced extension services. The road has also attracted the establishment of new manufacturing, food processing, and small and medium enterprises.

Improved transportation has strengthened provision of health services such as ambulance services and ease of access to hospitals and other health centers in Nairobi.

6.4.1.6: Upgrade of skills

The Nairobi-Thika Highway Improvement project has led to upgrade of skills of Kenyan technicians and professionals, managerial staff and clerical and administrative staff involved in the project. The collaboration between highly skilled employees from China and Kenyan counterparts ensured transfer of skills in civil engineering. The skills gained led to availability of highly qualified local civil engineers which minimizes the cost incurred in seeking services from expatriates.

6.4.2 The benefits of the Nairobi-Thika Highway Improvement Project to China

The Thika Highway project strengthened the diplomatic relations between Kenya and China. By awarding the tender for construction of the highway to Chinese contractors, the government of Kenya demonstrated good will toward business relations with China.

The construction of Thika Highway also provided employment opportunity for Chinese engineers and servicemen who worked for the companies that participated in the construction. The highway served as a marketing tool for Chinese companies because other countries may seek services from the same Chinese companies due to the good quality of work they did in Kenya. The improved business relation between Kenya and China has helped Chinese businesses to penetrate the Kenyan market. Chinese exports commodities such as furniture, textiles and machinery to Kenya.

6.5 The benefits of foreign investment to China

China has benefited from Foreign Direct Investment in number of ways. The benefits include: improved competitive advantage, increased participation in the international segmentation of production, improved specialization and increased domestic penetration of FDI firms. Domestic effects of foreign investment include increased source of capital, creation of jobs, upgrade of employee skills, better pay and increased technology transfer. Foreign investment has modified China's industrial structure and increased domestic competition.

6.5.1 Improved competitive advantage

China's competitive advantage in international trade has also increased due to increase in FDI. Specialization among Chinese investors has improved China's position in world trade. Initially China mainly exported leather products, clothing, carpets, miscellaneous manufacturing but the country has increased its market shares by exporting telecommunication, computer and other electronic equipment. China has been able to diversify its exports of labour intensive products and establish competitive positions in rapidly expanding markets, thus succeeding in sustaining a rapid export growth. This has made china one of the leading economies in the world.

6.5.2 Increased participation in the international segmentation of production

Exports from China have shifted from consumer goods to equipment goods and from one chain of production (textile industry) to another chain of production (electric and electronic industry). China has greatly increased export of electrical equipment and apparatus, computer equipment, telecommunication equipment to developing countries especially in Africa. This pattern of specialization indicates that China is involved in the international segmentation of the production process and specialized in the assembly and transformation of imported intermediate goods for export.

6.5.3 Improved specialization

International trade has accelerated structural changes in China's trade. Foreign direct investment had been the major factor behind the diversification in favour of more technologically advanced products with rapidly expanding markets. Foreign direct investment, driven by cost considerations, has induced China to build up competitiveness in new manufacturing sectors based on an in-depth specialization along the production process. China has specialized in production of goods by assembling of intermediate goods and components exported from other countries. As far as the imported intermediate products incorporate high technology, they may be a channel for technology transfer into the Chinese manufacturing industry.

6.5.4 Foreign investments as source of capital

Foreign investments have made a determinant contribution to China's domestic capital formation. The returns on foreign investment act as a source of capital for expansion of Chinese firms involved in rehabilitation of roads in Kenya. This allows the firms to venture into more international trade.

6.5.5 Creation of jobs

The creation of employment opportunities, either directly or indirectly, has been one of the most prominent impacts of FDI on the Chinese economy. Both total employment and urban employment in FDI firms in China have increased significantly. The contribution is

high in technology intensive sectors, such as electronic and telecommunication equipment, instruments and civil engineering.

6.5.6 Increased remuneration

As in other countries, FDI firms in China pay higher rates of employee compensation (wages, salaries, bonuses, and monetary and non-monetary fringe benefits) than domestic firms. FDI firms record higher labour productivity and have higher capital intensity than their local competitors. These higher levels of productivity reflect a higher capital to labour ratio. FDI firms are also larger than their local competitors and large firms usually pay higher wages than small firms. In some cases, foreign firms may feel the need to attract workers away from competing employers by providing higher wages.

6.5.7 Increased technology transfer

FDI firms possess superior ownership advantages and employ more technologically advanced production and marketing methods than domestic firms. This happens because firms must possess some kind of ownership advantages such as a patent, blueprint or trade-mark in order for it to invest abroad. FDI firms employ more technologically advanced production and marketing methods because specific intangible assets or capabilities such as technology and information, managerial, marketing and entrepreneurial skills, organizational systems and access to intermediate or final goods markets must be sufficient to outweigh the disadvantages of doing business abroad. Technology and managerial skills have been transferred to China by FDI firms.

6.5.8 Modification of China's industrial structure

The technology industry has been the most important recipient of FDI in China. The electronics & telecommunication equipment industry receives large amount of foreign investments. There is also large amount of foreign investment in transport equipment, non-metallic mineral products, electrical machinery & equipment, chemical materials & products, and clothing & other fiber products industries. FDI projects are larger, more oriented towards relatively capital intensive and technology intensive sectors, and more

oriented towards the international market. This has positive effects on the structure of the industry through capital and technology transfers.

6.5.9 Increased domestic competition

FDI firms have important part to play in the opening up of the Chinese economy to foreign competition. China's entry to the WTO has led to cuts in tariffs on industrial goods and to the phasing out of all quantitative restrictions on industrial imports. Domestic and foreign firms, therefore, face stronger competition from imports. Capital intensive industries such vehicles, electric and electronic goods, machinery may be affected by increased import competition. FDI firms participate in domestic market by selling transport equipment, electronics and telecommunication equipment, food processing, electrical machinery and equipment, textiles and chemical materials and products.

CHAPTER SEVEN

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

7.0 Introduction

This chapter presents the summary of the findings on the impact of international business relations on economic development in Kenya. The chapter also presents the conclusion and recommendations drawn from the findings.

7.1 Summary

7.1.1 China's foreign investment policies

From the literature reviewed in chapter two, China has aggressively shaped a relatively complete range of laws and regulations governing foreign investment. These laws include the Law of the People's Republic of China upon Foreign Wholly Owned Enterprises, Law of the People's Republic of China upon Sino-Foreign Joint Ventures, Law of the People's Republic of China upon Sino-Foreign Cooperative Enterprises, and the Guiding Directory on Industries open to Foreign Investment. China's laws and regulations on FDI also include related preferential policies and stipulations for special economic zones in the country.

In a nutshell, China encourages favourable FDI policies. Furthermore, the Chinese government has stipulated different FDI performance requirements depending on these distinctions. China has designated certain parts of the country as special economic areas and each is governed by different policies. China has also enforced two policies called Develop China's West at Full Blast and Strategy of Reviving Rusty Industrial Bases to encourage FDI into its western and northeast regions. Therefore, FDI policies in China's western region entitle foreign enterprises to even more preferential treatment than in other regions of the country.

China's policies for promoting the exports of FDI have been increasingly effective. China's processing trade policy, which exempts input imports for re-export from tariff and value-added tax (VAT), has improved the country's export value tremendously. Two kinds of processing trade exist in China: processing trade with imported materials and processing trade with materials supplied by clients. Prior to China's WTO membership, the country maintained a relatively high tariff level.

After China reformed its tax system in 1994, imports were subject to a new 17 percent VAT; and certain imports (e.g., the automobile industry) are further subject to a 10 percent excise tax. Under such a high tariff/VAT system, without any exemptions on imports for PTI or PTS, there would be an incredible decrease in Chinese exports. In order to eliminate this possibility, China implemented the exemption policy immediately after initiating its reform and open policies. Thus, imported raw materials and spare parts used in the export processing industry are exempt from tariff and VAT from the outset and any verification will occur after the finished goods have been exported.

Policy factors have also had a significant influence on FIE domestic purchases. As domestic supporting industries have evolved and improved and VAT reimbursement has been implemented, the percentage of local content of China's exports in the processing trade has markedly increased.

The most viable explanation for the difference lies in the "VAT reimbursement for exports" policy that China implemented toward these two different trading modes: domestically purchased materials used in PTI may be reimbursed but not in PTS. Essentially, companies engaged in PTI can receive a tax rebate equal to 17 percent of the value of domestically purchased materials, but PTS companies cannot. Such a cost difference is large enough to force enterprises to make a prudent decision on where to purchase materials: domestically or abroad. Although initiated to provide equal footing for domestic raw materials, the opposite effect has occurred. The difference between PTI and PTS in terms of the domestic value increment rate has indicated that the VAT reimbursement for exports policy has effectively impacted purchasing decisions of FIEs toward imported raw materials and spare parts.

China's policies to promote exports have also affected FDI. For example, an FIE with an export ratio higher than 70 percent receives a 50 percent corporate income tax discount.

7.1.2 The role of Government Ministries in promoting international business relations.

The study investigated the role of government ministries in promoting international business relations. The ministries investigated include Ministry of Trade, Ministry of Foreign Affairs, Ministry of Public Works and Ministry of Roads.

7.1.2.1 Ministry of Trade.

The Ministry of Trade has an important role in promoting international business relations. The Ministry of Trade is responsible for the promotion of trade domestically, regionally and internationally through creation of an enabling business and investment environment. The Ministry of Trade has the mandate to formulate and implement policies that govern trade development; promotion of retail and wholesale markets, development of micro and small business; implementation of fair trade practices and consumer protection; private sector development and participation in international trade affairs. The policy priorities within the Ministry of Trade are based on the pillars of trade and investment and are intended to enhance both local and international trade.

7.1.2.2 Ministry of Foreign Affairs

The study established that different individuals, institutions and organizations participate in the foreign policy formulation and decision-making. The Ministry of Foreign Affairs is a facilitator, coordinator and a steward of the country's foreign policy; the various government agencies are complementary actors in the conduct of foreign policy. In order to attract foreign investment the Ministry of Foreign Affairs has adopted strategies such as launching a private sector delivery partner with the incentive to attract and retain high-value investments; bringing more private sector expertise into its relationship with exporters and inward investors and developing partnerships with key businesses which support small and medium enterprises.

Kenya's foreign policy orientation has been designed to promote international trade relationships. Kenya's foreign policy is guided by basic and universally recognized

norms such as respect for sovereignty and territorial integrity of other states and preservation of national security, good neighbourliness and peaceful co-existence, non-interference in the internal affairs of other states, adherence to the Charters of the UN and OAU/AU. Several factors (e.g. security or political stability, economic advancement or development, geo-political factors and Kenya's participation in regional integration) influence the effectiveness of foreign policy towards promotion of international trade relationships.

7.1.2.3 Ministry of Roads and Ministry of Public Works

The Ministry Public Works is mandated to facilitate provision and maintenance of buildings and other public works in the country. The Ministry of Public Works has several strategies which ensures that it remain committed to both local and international clients. To the clients dealing with buildings, the Ministry of Public Works avails designs for public buildings, submit bills of quantities, source for tenders, issue final accounts on contracts and respond to emergencies immediately. To other public works, the ministry facilitates construction of sea walls and break waters to protect the land from sea wave action, facilitate transport on water (sea and lakes) by construction of jetties, improve communication in human settlements through construction of footbridges and provide necessary technical advice on rehabilitation and maintenance of seawalls and jetties. The Ministry of Roads on the other hand has been restructured into three operating authorities to provide efficient road network in urban, rural and across the border to open up the country to the neighbouring markets. The Ministry has a board to manage the fuel levy and ensure that all roads in the country are well maintained.

7.1.3 Kenya's involvement in multilateral trade agreements

Kenya fully subscribes to the charters of the United Nations and the Organization of African Union and seeks to work with like-minded states in the promotion of a new international political and economic order. Towards this end, Kenya continues to undertake its responsibilities in the context of UN system, World Trade Organization, IMF/World Bank and other multi-lateral bodies. Kenya is a member of the Commonwealth whose advancement in development interests other member countries.

The responsibility for concluding treaties involving the Republic of Kenya lies with the Ministry of Foreign Affairs. The Ministry has a treaty section within the legal division that keeps records of bilateral and multi-lateral treaties involving Kenya.

7.1.4 The benefits of the Nairobi-Thika Highway Improvement Project in Kenya

Several benefits have been associated with Nairobi-Thika Highway Improvement Project in Kenya. The benefits cited include: improved traffic flow into and out of Nairobi city, savings in time which result in higher economic productivity, improved access to social and economic centers, enhanced travel efficiency for commuters, enhanced returns to commerce and agriculture and upgrade of skills.

The benefits of the Nairobi-Thika Highway Improvement Project to China include: strong diplomatic relations between Kenya and China, creation of employment opportunity for Chinese engineers and servicemen who worked for the companies that participated in the construction. The highway served as a marketing tool for Chinese companies because other countries may seek services from the same Chinese companies due to the good quality of work they did in Kenya. East African Community member countries have prospects of involving Chinese contractors to improve infrastructure in the region. The improved business relation between Kenya and China has helped Chinese businesses to penetrate the Kenyan market. Chinese exports commodities such as furniture, textiles and machinery to Kenya. China has also invested in services and health sectors and more investors are expected to flow due to improved infrastructure.

7.1.5 The benefits of foreign investment to China

China has benefited from Foreign Direct Investment in a number of ways. The benefits include: improved competitive advantage, increased participation in the international segmentation of production, improved specialization and increased domestic penetration of FDI firms. Domestic effects of foreign investment include increased source of capital, creation of jobs, upgrade of employee skills, better pay and increased technology transfer, foreign investment has modified China's industrial structure and increased domestic competition.

7.2 Conclusion

The findings on China's foreign investment policies revealed that China's policies to promote foreign investments favour investments in Kenya and other developing countries. The study also revealed that different ministries have strategies for promoting local and international trade.

Both the governments of Kenya and China have good business relations which resulted in award of the tender to improve Nairobi-Thika Highway to Chinese contractors. The Nairobi-Thika Highway Improvement Project has contributed to enhancement of transport services and urban mobility in Nairobi by reducing general transport costs, improving accessibility to public transportation, employment opportunities, housing, and recreation activities. In addition, the project has promoted private sector participation in the management and operation of road infrastructure in Kenya. Therefore, the project has significant impacts on Kenyan economy. The Nairobi-Thika Highway Improvement Project is consistent with Kenya's development priorities of improved infrastructure stipulated in the vision 2030.

7.3 Recommendations

The study recommends the following:

- (i) Kenya invites other developed countries with favorable foreign investment policies as China's to invest in other areas of Kenyan infrastructure.
- (ii) Kenya puts in place investment measures and policies that will ensure that foreign investors involve more Kenyans in their work.
- (iii) Kenya increase bilateral trade with China and other development partners.
- (iv) The government of Kenya replicate similar project in other towns in Kenya and improve other modes of transport like rail, air and water.

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APPENDIX I: INTERVIEW GUIDE: MINISTRY OF FOREIGN AFFAIRS

RE: PARTICIPATION IN RESEARCH

I am a student pursuing a degree of Masters of Arts in International Studies and conducting a research entitled “The Impact of International Business Relations on Economic Development in Kenya: A Case study of Construction of Thika Highway by Chinese Contractors”. In this regard, you have been selected to take part in this study as a respondent.

You will not be identified from the information you provide and no information about individuals will be given to any organization. The data collected will be used for this academic research only.

Your participation is important for the success of this project and I greatly appreciate your contribution.

Yours Sincerely,

Florence Mugendi.

Kindly respond to the following questions:

1. What is the role of the Ministry in promotion of international business relations?
2. What are the strategies used by the Ministry to attract foreign investment?
3. a) Does foreign policy promote international trade relationships?
b) If yes, which provisions in foreign policy promote international trade relationships?
4. Which factors influence the effectiveness of foreign policy towards promotion of international trade relationships?
5. Which agreements have been signed between the government of Kenya and other nations to promote international trade?
6. Which initiatives has the government of Kenya put in place to promote economic and trade Cooperation between Kenya and China?
7. What are the economic benefits of Nairobi-Thika Highway Improvement Project to Kenya?
8. How will China benefit from the Nairobi-Thika Highway Improvement Project?

APPENDIX II: INTERVIEW GUIDE: MINISTRY OF TRADE

RE: PARTICIPATION IN RESEARCH

I am a student pursuing a degree of Masters of Arts in International Studies and conducting a research entitled “The Impact of International Business Relations on Economic Development in Kenya: A Case study of Construction of Thika Highway by Chinese Contractors”. In this regard, you have been selected to take part in this study as a respondent.

You will not be identified from the information you provide and no information about individuals will be given to any organization. The data collected will be used for this academic research only.

Your participation is important for the success of this project and I greatly appreciate your contribution.

Yours Sincerely,

Florence Mugendi

Kindly respond to the following questions:

1. What is the role of the Ministry in promotion of international business relations?
2. What are the strategies used by the Ministry to promotion of international trade?
3. How do policies within the Ministry promote international trade relationships?
4. Which initiatives has the government of Kenya put in place to promote trade between Kenya and China in the last five years?
5. What are the economic benefits of Nairobi-Thika Highway Improvement Project to Kenya?
6. How will China benefit from the Nairobi-Thika Highway Improvement Project?
7. Is the Thika Highway improvement project likely to attract more investors into the Kenyan market?

**APPENDIX II: INTERVIEW GUIDE: MINISTRY OF ROADS AND MINISTRY
OF PUBLIC WORKS**

RE: PARTICIPATION IN RESEARCH

I am a student pursuing a degree of Masters of Arts in International Studies and conducting a research entitled “The Impact of International Business Relations on Economic Development in Kenya: A Case study of Construction of Thika Highway by Chinese Contractors”. In this regard, you have been selected to take part in this study as a respondent.

You will not be identified from the information you provide and no information about individuals will be given to any organization. The data collected will be used for this academic research only.

Your participation is important for the success of this project and I greatly appreciate your contribution.

Yours Sincerely,

Florence Mugendi

Kindly respond to the following questions:

1. What is the role of the Ministry in promotion of international business relations?
2. What are the strategies used by the Ministry to improve infrastructure in Kenya?
3. How do policies within the Ministry promote international business relationships on infrastructure development?
4. Which initiatives has the government of Kenya put in place to promote Chinese investment in Kenyan infrastructure in the last five years?
5. What are the economic benefits of Nairobi-Thika Highway Improvement Project to Kenya?
6. How will China benefit from the Nairobi-Thika Highway Improvement Project?
7. Are there any plans for the Ministry to expand Road improvements projects in other parts of the country?

**APPENDIX II: INTERVIEW GUIDE: MANAGING DIRECTORS OF THE
CHINESE COMPANIES**

RE: PARTICIPATION IN RESEARCH

I am a student pursuing a degree of Masters of Arts in International Studies and conducting a research entitled “The Impact of International Business Relations on Economic Development in Kenya: A Case study of Construction of Thika Highway by Chinese Contractors”. In this regard, you have been selected to take part in this study as a respondent.

You will not be identified from the information you provide and no information about individuals will be given to any organization. The data collected will be used for this academic research only.

Your participation is important for the success of this project and I greatly appreciate your contribution.

Yours Sincerely,

Florence Mugendi

Kindly respond to the following questions:

1. How do foreign investment policies in China promote international business relationships?
2. Describe the economic relationship between Kenya and China.
3. Which initiatives has Chinese government put in place to promote foreign investment in Kenya in the last five years?
4. What are the economic benefits of Nairobi-Thika Highway Improvement Project to Kenya?
5. How will China benefit from the Nairobi-Thika Highway Improvement Project?
6. What are the benefits of Nairobi-Thika Highway Improvement Project to your companies?

**APPENDIX II: INTERVIEW GUIDE: ECONOMIC AND COMMERCIAL
COUNSELOR AT CHINESE EMBASSY IN KENYA**

RE: PARTICIPATION IN RESEARCH

I am a student pursuing a degree of Masters of Arts in International Studies and conducting a research entitled “The Impact of International Business Relations on Economic Development in Kenya: A Case study of Construction of Thika Highway by Chinese Contractors”. In this regard, you have been selected to take part in this study as a respondent.

You will not be identified from the information you provide and no information about individuals will be given to any organization. The data collected will be used for this academic research only.

Your participation is important for the success of this project and I greatly appreciate your contribution.

Yours Sincerely,

Florence Mugendi

ly respond to the following questions:

1. How do foreign investment policies in China promote international business relationships?
2. Describe the economic relationship between Kenya and China.
3. Which initiatives has Chinese government put in place to promote foreign investment in Kenyan in the last five years?
4. What are the economic benefits of Nairobi-Thika Highway Improvement Project to Kenya?
5. How will China benefit from the Nairobi-Thika Highway Improvement Project?
6. Are there other present or future initiatives by Chinese government to increase bilateral trade with Kenya?

Kindly respond to the following questions:

1. How do foreign investment policies in China promote international business relationships?
2. Describe the economic relationship between Kenya and China.
3. Which initiatives has Chinese government put in place to promote foreign investment in Kenya in the last five years?
4. What are the economic benefits of Nairobi-Thika Highway Improvement Project to Kenya?
5. How will China benefit from the Nairobi-Thika Highway Improvement Project?
6. Are there other present or future initiatives by Chinese government to increase bilateral trade with Kenya?