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KENYA ECONOMIC AND POLITICAL TRANSITION PROJECT FOR ECONOMIC RECOVERY

Corruption, Firm Growth and Export Propensity: Findings from Kenyan Manufacturers

Introduction

Surveys of manufacturing firms over the last decade have shown that business persons based in Kenya view corruption as a major hurdle to corporate pursuit. Other governance-related surveys have also concluded that Kenya is an increasingly corrupt country. Recognizing this state of affairs, the new Government took the challenge to fight corruption right from the first year of its power, and has legislated accordingly. Kenya's Parliament has already passed the Public Ethics Bill and the Anti-Corruption and Economic Crimes Bill.

The new government also moved quickly to form a Ministry of Justice and Constitutional Affairs, with a mandate of coordinating the war against corruption in Kenya. The creation of the position of Permanent Secretary in the Office of the President in charge of public ethics and governance is a further step in the effort to fight corruption. Unfortunately, the fight against corruption has not benefited from substantive evidence about who is most exposed and how the exposure to corruption is structured. Furthermore, there is very little information on the retrogressive consequences of corruption. Because business persons are now more open about the vice, it is possible to gather high quality corruption-related data and subject such data to rigorous analysis to build a stock of knowledge on which the fight against corruption can be founded and anti-corruption interventions sharpened.

This policy brief is based on a recent study by KIPPRA on *Corruption, firm growth and export propensity: Findings from Kenyan manufacturers*. The study is based on extensive data collected in year 2003 through a KIPPRA/World Bank survey on the business environment in Kenya. The brief reports on the main findings and conclusions of the study.

Main findings

Locus and Burden of Corruption

In Kenya, like in many other countries, the government is a major buyer of goods and services produced by private firms. By the sheer size of government, government contracts are lucrative and attract a lot of interest from private firms. However, not all firms receive government contracts. Those that receive government contracts often have to part with some unofficial payments or kickbacks to government officials. The results of the study show that firms pay on average 7.5% of the total contract value in form of kickbacks. The results also show that the amounts paid vary considerably by sector. It ranges from 4% of contract value in the machinery sub-sector to 11.5% in the paper, printing and publishing sector. Besides the paper sector, other sectors that attract relatively high kickbacks are textile, garments and leather (9%), wood and furniture (8.9%) and metal sector (8.8%). The average proportion of annual sales paid out as bribery is 4% and ranges from 1.3% for agro-businesses and 1.5% for chemicals and paints to 8.4% and 7.8% for machinery and furniture/woodwork, respectively. Considering this measure of corruption, firms in the machinery sector pay the highest proportion of annual sales as bribe.

In terms of location, Nairobi-based firms bear the brunt of corruption; firms based in the city pay the highest amounts of unofficial payments on most counts. The highest average unofficial payments are for utilities and electricity. Firms located in Nakuru also pay more than average percentage of their annual sales and contract values as unofficial payments.

There is a size factor in the locus of corruption. The very small firms make lower unofficial payments in respect of licenses and other services. However, the small and medium-sized firms spend the largest percentage of their annual revenue and value of government contracts in unofficial payments (see chart). Ironically, the very large firms spend the smallest amounts in unofficial payments; they spend the smallest proportion of annual sales and a smaller proportion of contract value on government contracts on unofficial payments.

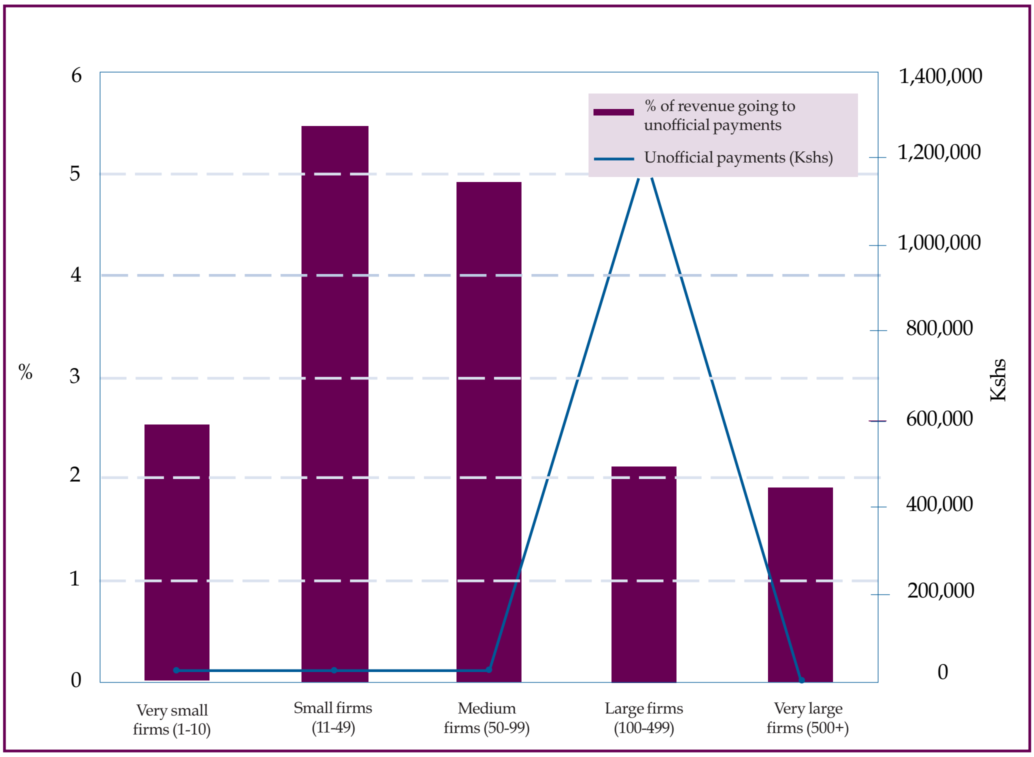
Structure of Corruption

What determines corruption? In other words, what indicators—firm level, sectoral or macroeconomic—are associated with corruption in Kenya? An econometric analysis of the structure of corruption in Kenya yielded the following results:

- There is a very strong positive relationship between the proportion of annual sales spent in unofficial payments and the number of politicians that business persons know and trust enough to talk freely about business. In other words, the proportion of annual sales that firms spend on unofficial payments increases with the number of politicians that the proprietors of such businesses know and trust.

  Harambees are a possible conduit for unofficial expenditures that are made in exchange for certain favours, including access to government contracts. The number of civil servants known by business persons has the reverse effect on the proportion of total sales spent on unofficial payments. That is, interaction with public servants reduces the proportion of total sales spent on unofficial payments.

- Unofficial payments in respect of licenses and the network variables have opposite effects. Such unofficial payments increase with the number of public servants known, but decline with the number of politicians known. In other words,



while public servants extract unofficial payments in issuing licenses, politicians assist business persons to circumvent bribery extraction in the issuance of business licenses.

- The effect of the irreversibility of investments varies across different measures of corruption. Irreversibility is not particularly important for the proportion of annual sales spent on unofficial payments. However, it is somewhat positively associated with the unofficial expenditure on utilities and especially such unofficial expenditure as business licenses. The bargaining position of firms whose investments are less reversible is weak, such that it is easier to extract utility and business license related bribery.
- Although the results are weak, there is some indication of a possible inverse relationship between the completeness of tax reporting and bribery paid out. Therefore, firms that report a percentage of their revenues in their tax returns make more unofficial payments on business licenses as proportion of their annual sales.
- Although trade variables (exporting and use of imported raw materials) do not generally yield any significant results, firms that export some of their produce pay significantly higher unofficial payments in respect of licenses than those that do not export. There are three possible explanations for this. First, exporting firms follow tight production and shipment schedules such that their cost of waiting for licenses is high. They are therefore more likely to offer speed money in accordance with the queuing theory of corruption. Second, an exporter faces more licenses, therefore interacts with more public servants, and is more likely to encounter corrupt public servants than a non-exporter. Third, the act of exporting may fuel perceptions of higher profitability leading to greater extraction of bribery.
- There are no significant firm size differences when it comes to exposure to corruption. However, machinery, woodwork and paper/printing firms spend significantly greater proportions of total sales on unofficial payments than agro-processing firms (used as benchmark) and firms in other sectors. On the other hand, construction firms make lower unofficial payments in respect of utilities than agro-processing and other firms. However, being in the construction sub-sector shows a significantly positive association with the proportion of unofficial payments on value of government contract than being in agro-processing and other sectors. In other words, kickbacks on government contracts are a unique feature of firms in the construction sector.
- Firms located in Kisumu pay a significantly greater proportion of their annual sales in bribery than those based in Nairobi. On the contrary, firms based in Mombasa and Eldoret spend a significantly smaller proportion of value of annual sales on unofficial payments than those based in Nairobi. These location differences are inexplicable.
- The results also reveal co-movement between corruption and red tape. Paying bribery in the Kenyan context does not necessarily speed-up transactions or services. Senior managers of firms that make more extraordinary payments especially for utilities still spend more time chasing connections, licenses, permits and tax assessments. Bribery does not fast-track public services.

Firm Growth, Export Propensity and Corruption

What does exposure to corruption mean for firm performance? To investigate the relation between corruption and firm performance, a model of firm growth and export propensity was estimated. The results show that corruption, however measured, has a negative effect on firm growth. Firms that make more unofficial payments either as a proportion of total annual sales, for utilities, licenses, or as a proportion of the value of government contracts grow less slowly. Corruption also makes it less likely for firms to export. In other words, firms that are exposed to corruption find it hard to participate in external markets.

Conclusion

For some time now, it has been acknowledged that there is a lot of corruption in Kenya. The new Government has been fighting the vice since the time it came to power and has been legislating accordingly. However, the fight against corruption has not benefited from substantive evidence about who bears the worst of the vice or even how corruption in the business environment is structured. There has been very little clear evidence of the retrogressive consequences of corruption.

Evidence generated by research at KIPPRA has demonstrated that although not all manufacturing firms in Kenya receive government contracts, those that receive such contracts pay kickbacks to public servants. This, however, varies from one sector to the other. The evidence also shows that there are important firm size and location differences in the exposure to corruption.

The evidence also demonstrates an inverse, albeit weak relationship between the completeness of tax reporting and corruption-related payments, leading to the conclusion that firms that report a lower percentage of their revenues in their tax returns pay more bribery.

Lastly, firms that export at least part of their manufacturing production pay significantly higher unofficial payments in respect of licenses than those that do not export. This is because exporting firms follow tight production and shipment schedules, such that their cost of waiting for licenses is high. They are therefore more likely to offer speed money in accordance with the queuing theory of corruption. They also face more licenses and interact with more public servants, increasing their exposure to corruption. The actual act of exporting brings perceptions of higher profitability, therefore deepening exposure to corruption.

Recommendations

These firm-level findings add to a growing volume of literature demonstrating the retrogressive consequences of corruption. The findings provide further reason for intensifying the fight against the vice. To intensify the war on corruption:

- An appropriate legal and institutional framework for fighting corruption should be set up in Kenya. The recent legal and institutional changes are a step in the right direction and should be enhanced.
- The Government procurement system should be reviewed and strengthened to make it more transparent and accountable. The pending Procurement Bill in Parliament should be enacted as a matter of urgency.
- All institutions charged with fighting corruption need to have their capacity to do so enhanced.
- The corporate sector should focus and embrace corporate governance, and help the government in fighting corruption. The government should facilitate the development of rules and regulations for corporate governance.

About KIPPRA Policy Briefs

KIPPRA policy briefs are aimed at a wide dissemination of the Institute's policy research findings. The findings are expected to stimulate discussion and also build capacity in the public policy making process in Kenya.

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