

MICROECONOMICS OF COMPETITIVENESS

COUNTRY: KENYA

CLUSTER: TEA

BY:

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INTRODUCTION

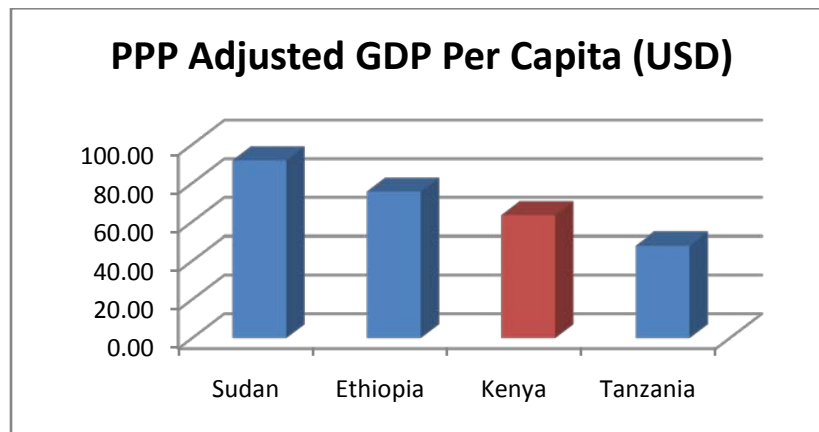
Unlike its neighbors, Kenya is located in East Africa with good access to the sea. In 2007, its aggregate GDP was composed of the service sector (59%), agriculture (24%), and industry (17%) (EIU, 2009). It has gained international prominence for its breadth of tourism attractions as well as its location as a gateway

to Eastern Africa. Since independence, it has had three presidents: Jomo Kenyatta (1963 – 1978); Daniel Arap Moi (1978 – 2002); and Mwai Kibaki (2002 – Present).

ECONOMIC PERFORMANCE

Although Kenya's PPP adjusted GDP per capita growth – from \$ 31.42 in 1996 to \$63.39 in 2009 - is commendable, it is outstripped by its neighbors from a relatively lower starting point in 1996 (EIU, 2009).

Figure 1: Comparison of PPP Adjusted GDP Per Capita



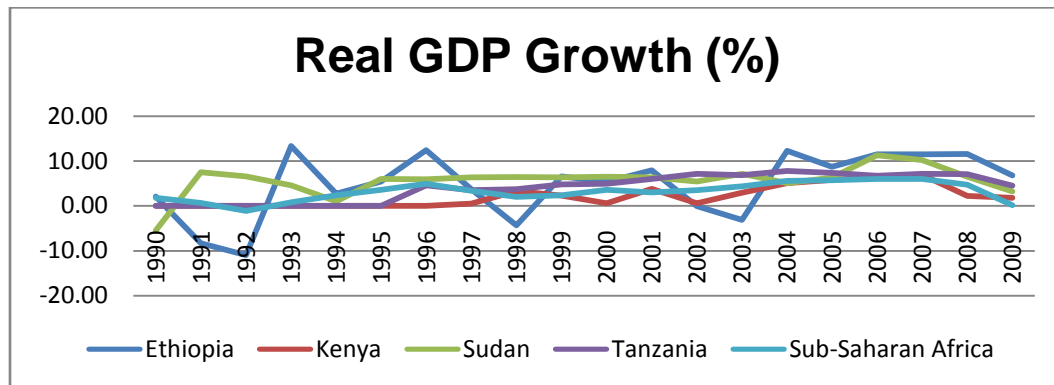
Between the mid-1990s and 2007, the real GDP growth rate of Kenya has been modest and steady. However, since 2007 it has been declining much faster than neighboring countries (EIU, 2009). This has coincided with the post-election civil disturbances which saw tourism receipts plummeting to a record low.

Kenya Summary

Independence	1963
GDP per capita, PPP	\$1,542
Gini Index	48
Population	37,530,726
Life Expectancy at Birth	54
Land Area (sq. km)	56,9140

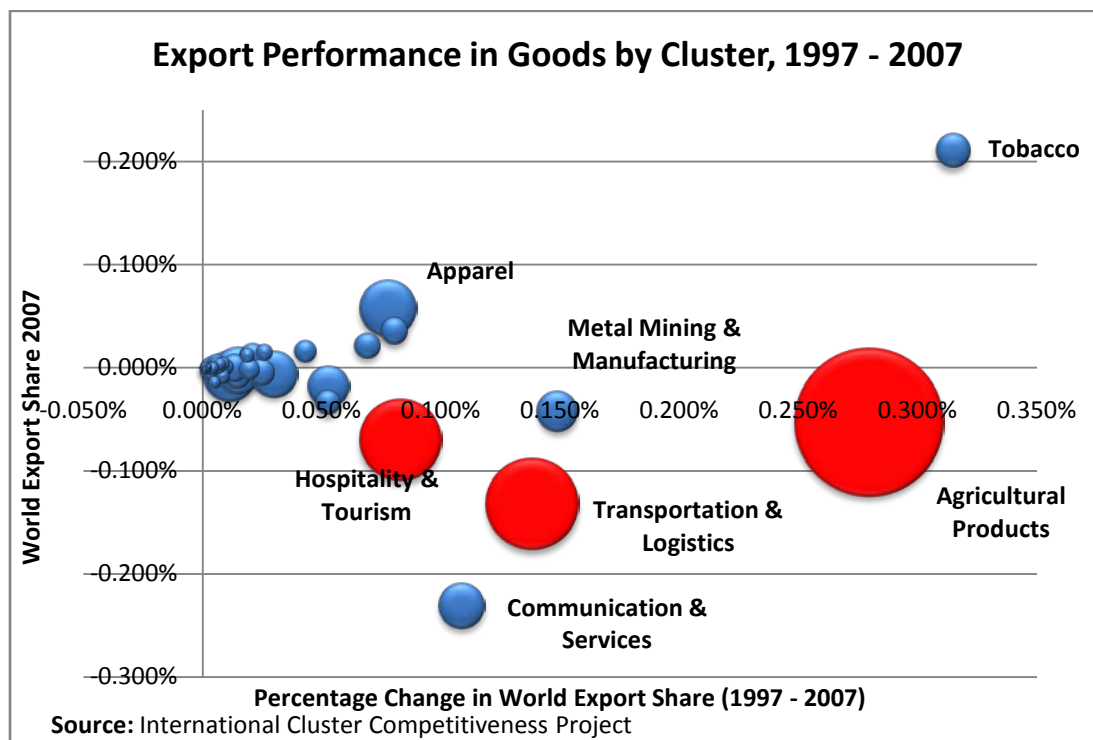
Source: WDI 2008

Figure 2: Comparison of Real GDP Growth Rate



As figure 3 highlights, the clusters that have the highest volume in Kenya's export share are Agricultural Products, Transportation & Logistics, and Tourism & Hospitality. However, their share in world export portfolio is very minimal. Moreover, its export share of agriculture has been declining in recent years.

Figure 3: Kenya's Export Performance in Goods by Cluster 1997-2003



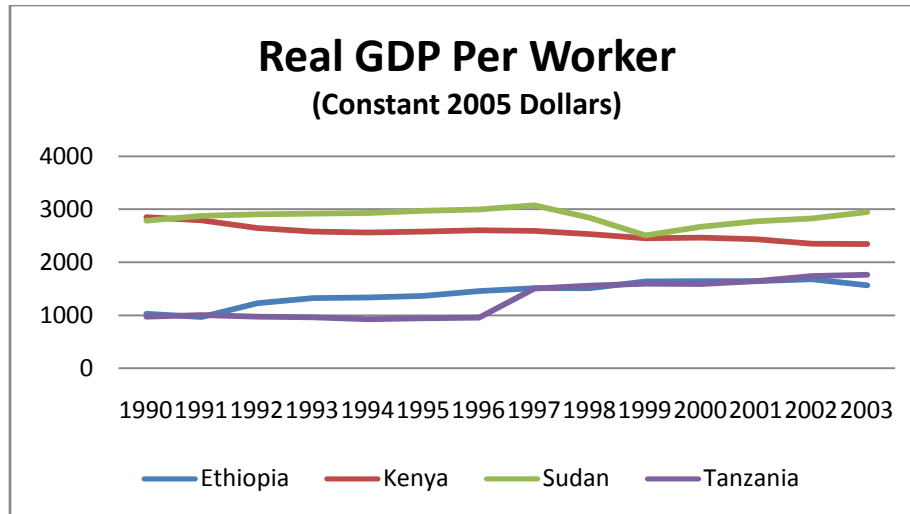
POLITICAL CONTEXT

The political crisis and subsequent violence that ensued after the 2007 elections was a blemish on Kenya's reputation as a relatively stable country in its neighborhood. In early 2008, supporters of President Kibaki and the opposition leader Raila Odinga took an election dispute to street violence (Prunier, 2008). The crisis saw over 1000 people dying and close to 350,000 displaced – causing major disruptions on economic activity (IMF 2008). The tourism sector which accounts for 10.8 % of GDP and 8.7% of national employment was hit the hardest with a 90 % decline in February 2008 (World Travel & Tourism Council 2008)

Like in its neighbors, the socioeconomic condition of Kenya is beset with a public health crisis. With HIV prevalence rate of 6.1% (one of the highest on the continent) in the 15-49 age group, Kenya's life expectancy has been eroded to 54 years at birth (HDR, 2008; WDI 2008). Furthermore, the Human Development Report ranked Kenya 148th out of 177 countries (HDR, 2008). At the same time, primary and secondary school enrollment rates have risen, thanks in large part to the abolition of school fees for primary and secondary education in 2003 and 2008 respectively.

Although labor productivity is higher than the average in its neighborhood, since 1990 it has been on a declining trajectory while Sudan is steadily outpacing Kenya's rate of labor productivity growth. The World Bank's Investment Climate Assessment indicates that although manufacturing value added labor productivity of Kenya is comparable to that of China and India, it has been characterized by a much higher capital intensity (WB; 2008). This suggests that the level as well as quality of skills development will need to improve to be competitive globally.

Figure 4: Comparison of Labor Productivity Growth



In addition, the growth rate of Total Factor Productivity (TFP) which also accounts for capital utilization, increased only by 4 percent annual rate on average over the past four years, primarily due to utilization of existing capacity rather than new investment (WB; 2008).

Assessment of National Business Environment

Kenya's Global Competitiveness

Ranked 108th out of 134 countries in the World Economic Forum's Global Competitiveness Report, Kenya's global competitiveness is weak by global standards. However, compared to its neighbors, it is in a relatively stronger position.

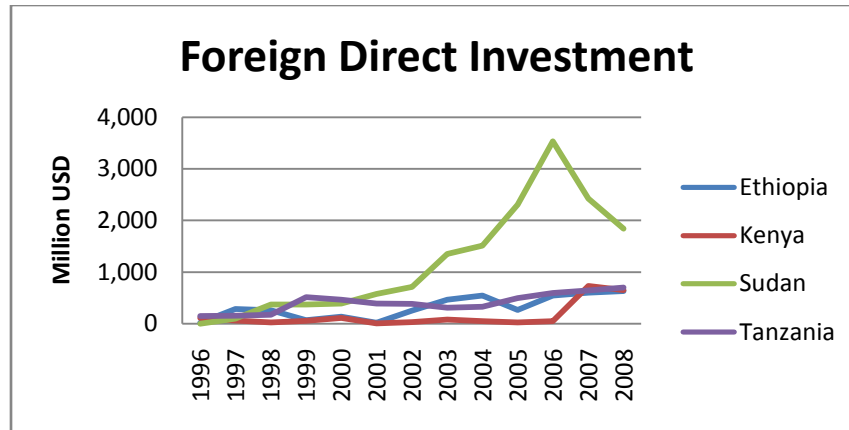
Table 1: Competitiveness Ranking

Global Competitiveness Ranking	2008
Kenya (out of 137 countries)	108
Ethiopia (out of 137 countries)	127
Tanzania (out of 137 countries)	114

Source: World Economic Forum, Global Competitiveness Report, 2008

Taking levels of Foreign Direct Investment as a proxy for attractiveness of the business climate for investment, we observe that it has been dismal until 2006 and currently stands closer to the level of its neighbors, Tanzania and Ethiopia.

Figure 5: Regional Comparison of Foreign Direct Investment



The story is consistent with the World Bank's Doing Business Ranking, where Kenya ranks 82 out of 181 countries. Although is low by global standards, regionally Kenya is in a very competitive position compared to its neighbors (Table..). According to the World Bank Study, Kenya ranks particularly well in dealing with (construction) permits and ease of access to credit for entrepreneurs.

Table 2: Doing Business Ranking

Economy	Kenya	Ethiopia	Sudan	Tanzania
Ease of Doing Business Rank	82	116	147	127
Starting a Business	109	118	107	109
Dealing with Construction Permits	9	59	135	172
Employing Workers	68	95	144	140
Registering Property	119	154	35	142
Getting Credit	5	123	131	84
Protecting Investors	88	113	150	88
Paying Taxes	158	37	67	109
Trading Across Borders	148	152	139	103
Enforcing Contracts	107	78	143	33
Closing a Business	76	74	181	111

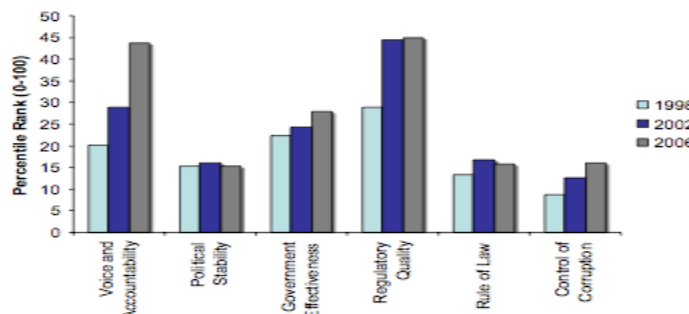
Source: *Doing Business Report 2009*

However, the following areas in particular need improvement to enhance the competitiveness of Kenya regionally as a place for doing business: paying taxes and enforcing contracts. Even with the recent reduction in tax rates, Kenyan firms are required to pay half of their corporate income in taxes while the profit tax rate for firms

stands at a whopping 32.5 percent (World Bank 2008). This high tax rate leads to evasion as well as a spawning informal sector. Equally, the tax administration system needs to be simplified with approximately one-third of firms surveyed rating it as a bottleneck. Firms report spending an average of 430 hours in preparing, filing, and paying taxes (World Bank 2008).

According to the Investment Climate Assessment, for firms in the top 75th percentile of labor productivity and employment, corruption remains one of the most severe constraints (World Bank 2008). According to Transparency International's Corruption Perception index, Kenya ranks poorly compared to neighboring countries – 147th compared to Tanzania's 102 and Ethiopia's 126 (TI online database).

Figure 5: World Bank Kaufmann Governance Indicators

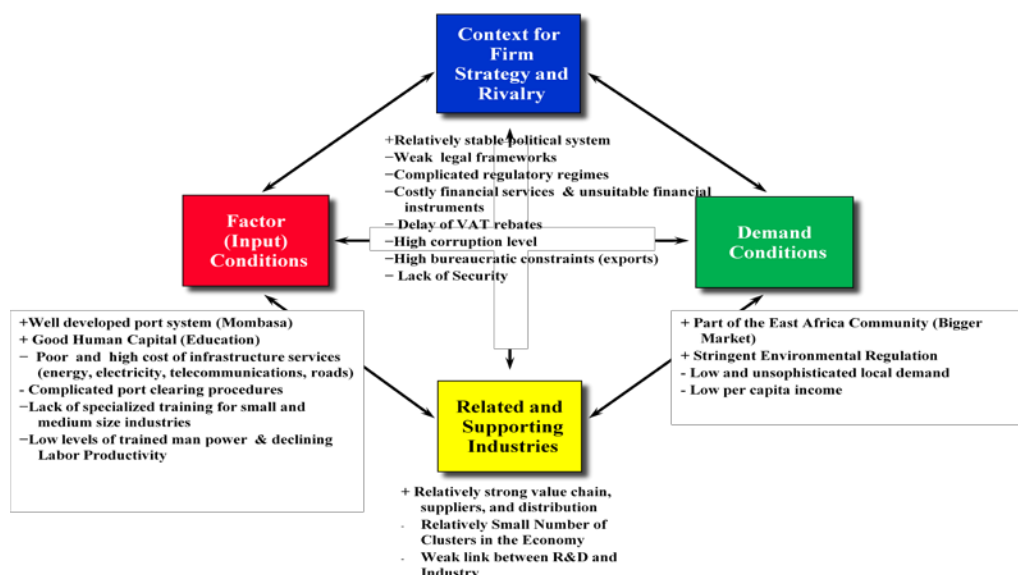


This is further confirmed by the World Bank's governance indicators where Kenya's ratings for "Rule of Law" (-1.02) and "Control of Corruption" (-0.98) are much worse than the regional averages of -0.73 and -0.83 respectively. According to Investment Climate Assessment, corruption costs Kenyan firms a conservatively estimated 4 percent of sales (World Bank 2008). In addition, according to Enterprise Surveys, the percentage of firms that report expectations of paying informal bribes to public officials stands at a

high of 79 percent – much higher than the African average of 41 percent. Worse still, the same survey indicates that the percentage of firms who report having to give gifts to secure government contracts stands at 71 percent (Enterprise Surveys, 2007). This strongly underscores that corruption is a serious impediment in the business environment that requires more intensive policy engagement.

National Diamond

Using the country diamond framework (Porter, 1998), Kenya's business environment was assessed along the following dimensions: factor (input) conditions; demand conditions; context for firm strategy and rivalry; and related and supporting industries. Assessment of *factor (input) conditions* indicates that Kenya benefits from relatively strong human capital as compared to its neighbors. In particular, the strong historical emphasis on education and the introduction of recent government policies on free primary and secondary education have placed Kenya on a better competitive position regionally. Although Kenya has a very well-developed port (Mombasa), other areas of infrastructure are impediments to the country's competitiveness. Poor quality roads, high cost of energy, and insufficient electricity supply need dramatic improvement.



The Global Competitiveness Report ranks the overall logistical infrastructure of Kenya at 83 out of 134 countries, while its communication infrastructure is ranked even lower at 112 out of 134 countries. According to the Investment Climate Assessment, close to 80 percent of firms in Kenya lose up to seven percent of sales due to power disruptions, which are among the highest in cross country comparisons (World Bank 2008). In addition, though the Mombasa port serves regional neighbors, the poor quality of the road infrastructure combined with complicated port clearing procedures drive up costs. Low levels of skills development as evidenced by declining labor productivity is confirmed by the Enterprise Survey data which indicates that only 40 % of firms in Kenya offer formal training to their employees (Enterprise Surveys 2009). Large manufacturing and export-oriented firms identify lack of specialized training as one of the biggest bottlenecks. Put in international context, Kenya lags behind comparator countries with respect to on-the-job training. Whereas 70 percent of firms in China and 60 percent in South Africa provide on-the-job training, only 40 percent of Kenyan firms provide training to their employees (World Bank 2008).

On *Demand Conditions*, Kenya benefits from access to a much larger regional market as a member of the East Africa community. However, its neighbors are similarly characterized by low per capita income levels which implies low, unsophisticated local and regional demand for Kenya.

On the *context for strategy and Rivalry*, Kenya is characterized by politically relatively stable – notwithstanding the recent post-election violence in 2007. Although the business environment has improved considerably since President Kibaki came to power, there are a number of areas of improvement to upgrade the country's competitiveness. Financial services are costly while financial instruments are not always business friendly. High levels of corruption, concerning crime rates, and weak legal institutional frameworks compound the business environment. Nearly 70 percent of firms surveyed in Enterprise Surveys ranked corruption as a binding constraint (World Bank 2008).

On *Related and Supported Industries*, Kenya benefits from relatively strong value chains and distribution channels as well as suppliers. However, there are relatively small number of clusters in the economy as a whole and the link between the relatively strong research institutions and manufacturing industry will need to be strengthened to spur innovation.

STRATEGIC ISSUES

Current Policies

Kenya vision 2030 is the new long -term development blueprint of the country. The aim of the development strategy document is to build a “ globally competitive and prosperous country with a high quality of life by 2030” (Kenya Vision 2030, 2007). Current efforts

of the government of Kenya are focused on macroeconomic stability, continuity in governance reforms, enhanced equity and wealth creation opportunities for the poor, infrastructure, energy, science, land reform, human resource development, security and public reforms.

Specifically, the government of Kenya has committed to improving the investment climate. In 2007, the government launched its first-ever Private Sector Development Strategy, which underscores that growth can only be achieved through prosperous private sector (WB-ICA, 2008). The new private sector strategy is based on five pillars: Improving Kenya's business environment, accelerating institutional transformation, facilitating growth through greater trade expansion, improving productivity of enterprises, supporting entrepreneurship, and small and medium enterprise.

CURRENT CHALLENGES

Although Kenya has recorded some progress in improving productivity, the Kenyan Private sector still faces a challenging business environment. An assessment of the Kenyan business environment indicates that the top constraints identified by Kenyan companies include high tax rate, corruption, limited access to finance, poor infrastructure services (especially electricity and transportation), and business licensing. Although Kenya has reduced the tax burden, in particular, the corporate tax rate, comparison with Kenya's comparator countries indicate that Kenyan firms are still required to pay a high percentage of tax. In addition Kenya maintains different kinds of fees and taxes on production inputs and services (WB-ICA, 2008). One potential impact of such a high tax burden is tax evasion, as well as the presence of a large informal sector. Going forward, broadening the tax base and reducing the tax rate is a better strategy. Corruption still remains one of the top bottlenecks for doing business in Kenya. According to the World

Bank's Investment Climate Assessment (2008), a staggering 75% of firms in Kenya reported having to make informal payments to get things done. Corruption costs Kenya firms approximately 4 % of annual sales, which is a considerable amount by international standards.

Electricity and transport are the main infrastructure bottlenecks affecting Kenyan firms. Close to 80 percent of firms in Kenya experience losses because of power interruptions. This is the highest value of all comparator countries (WB,2008). As a consequence, almost 70 percent of firms have generators, which are costly to obtain and operate. Power disruption costs Kenyan firms approximately 7 percent of sales (WB, 2008).

Access to credit is significantly more difficult for microenterprises and small enterprises. Access to credit is particularly difficult for small enterprises because, compared to medium and large firms, report that collateral requirements discouraged loan applications. The complexity of the application process is another impediment for micro and small firms.

POLICY RECOMMENDATIONS

Kenya needs to improve its business environment by catalyzing public-public sector dialogue while at the same time building adequate and good quality infrastructure in transportation and energy. To address these constraints, the following specific recommendations are suggested.

Tax Reform: Kenya has recently reduced the tax rate faced by corporations. This is commendable. However, the government should also considering broadening the tax base and improving the administration of the tax system while reducing the tax burden on production inputs and services

Anti -Corruption Campaign: Intensify the anti-corruption program already in place through better investigation and prosecution, eliminating discretionary decision-making in a public service that is prone to bribery, public education; supporting the development of a code of conduct within the private sector and judicial and legal reform, improve efficiency and effectiveness of the service delivery in public sector.

Improve Infrastructure: Increase public investment in transport infrastructure, energy generation, transmission, and distribution to increase connectivity; encourage increased private financing, and investment in the infrastructure sector, develop the legal framework for investments in energy, transport, telecommunication, provide incentives to attract FDI, cultivate a social attitude of respect and care for public infrastructure facilities and services amongst all citizens.

Access to Finance: Access to credit by small Kenyan business is fraught with immense difficulties. To address these constraints the government needs to design a development of a policy framework for SME financing that provides mechanism for, preferential loan, and credit guarantees. It is also important to promote the application of innovative products and technology by microfinance institutions to expand access to finance. Efforts to computerize property registration process should also continue as the ability to easily transfer land titles is an important vehicle for providing property owners with access to collateralized financing.

THE GLOBAL TEA INDUSTRY

Origin

Tea was introduced by the British in India, Sri Lanka, and by the Dutch in Indonesia. Later, in the 20th century commercial production began in Kenya, Tanzania, and Malawi. Tea is produced by more than 35 countries. Global production in 2006 reached 3.5

million tons. Three quarters of this production is accounted for by the top four producers, China, India, Sri Lanka, and Kenya (SOMO; 2007). Given the labor intensive nature of its production, millions of rural populations depend on the industry for their livelihoods.

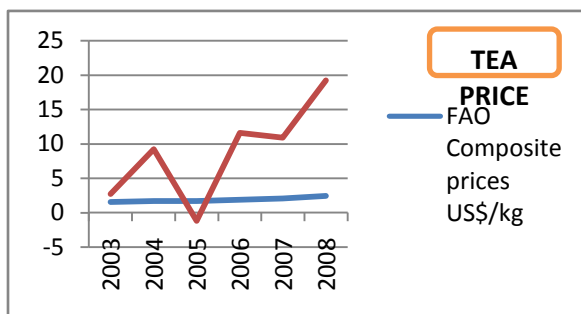
Table 3: Global Tea Production and Exports 2006

Country	Production	Share	Export	Share
China	1,028,064	0.29	286,549	0.18
India	995,907	0.27	200,866	0.13
Sri Lanka	310,822	0.09	314,915	0.20
Kenya	310,607	0.09	313,721	0.20
Turkey	142,000	0.04	5,500	0.00
Indonesia	140,049	0.04	95,339	0.06
Vietnam	132,000	0.04	106,666	0.07
Japan	99,500	0.03	1,681	0.00
Argentina	80,000	0.02	70,723	0.04
Bangladesh	53,265	0.02	4,794	0.00
Malawi	45,010	0.01	41,963	0.03
Uganda	36,726	0.01	32,699	0.02
Tanzania	31,348	0.01	24,132	0.02
Iran	20,000	0.01	6,000	0.00
Taiwan	19,345	0.01	1,962	0.00
Other	128,157	0.04	64,920	0.04
Total	3,532,800		1,571,808	

Kenya and Sri Lanka control 40 percent of world exports and have large smallholder subsector (SOMO; 2007) Tea production is therefore important within the economy and is a critical form of export income.

While domestic consumption of tea in Kenya accounts for 5 percent of production, 56% of all tea produced

worldwide is consumed locally. In the last 3 decades world tea production has doubled but demand has lagged behind creating a situation of oversupply (Agritrade; 2008). Until



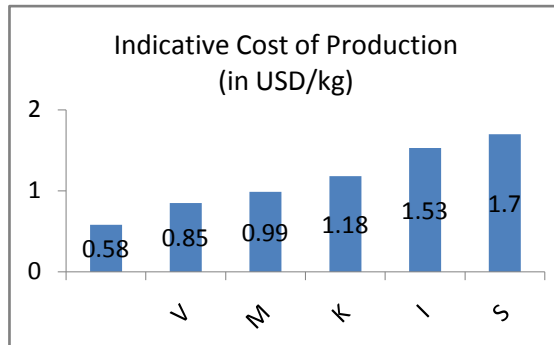
recently the price trend for tea has been downward. According to the Food and Agriculture Organization (FAO) composite index the price of tea has been gradually increasing. However longer term analysis

taking inflation into account indicates that the real tea price dropped substantially as producers now receive less than half what they did 3 decades ago (Agritrade; 2008).

Low world market prices and high production costs have put pressure on working conditions (i.e. casualisation of labor and inadequate health and safety conditions), and

affected modes of tea production (i.e. increased small holder, out-grower models, employee buy-out production). These conditions have driven various levels of restructuring of the sector in major producing countries.

Figure 6: Cost of Production (USD/kg)



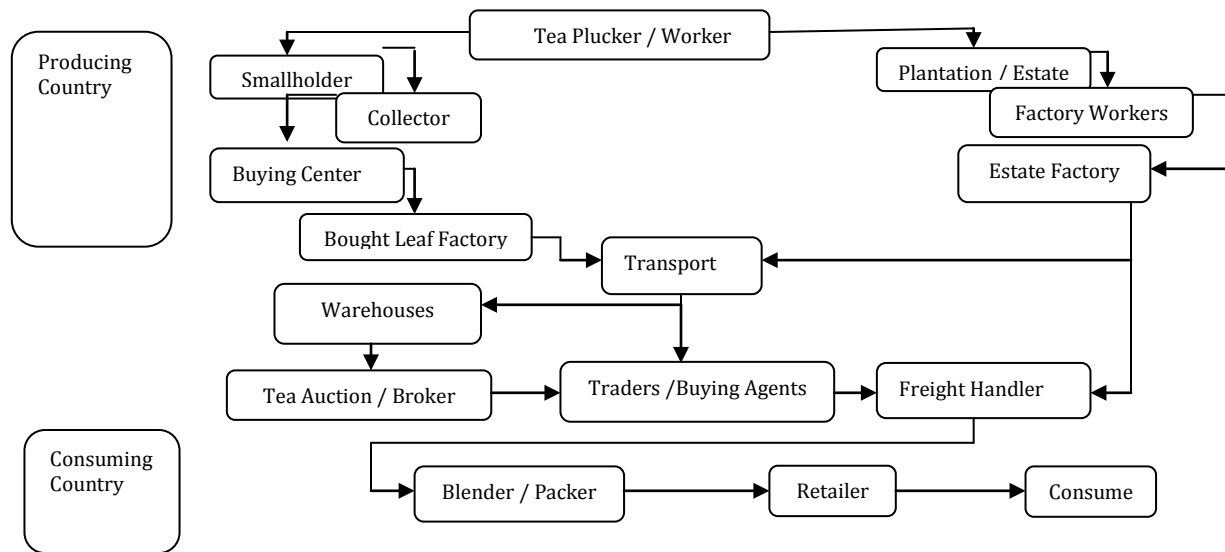
This restructuring of the industry ranges from dismantling of the plantation system in India to the rise of smallholder production in Sri Lanka.¹ These two countries have the highest production costs

owing to older and lower-yielding tea bushes, low labor productivity in Sri Lanka. In addition in both countries there has been a negative impact on environment through high agrochemical usage and deforestation. Information on the Chinese Tea industry is not readily available. Kenya is considered a tea exporting “super power” of Africa with only Sri Lanka exporting as much tea globally. Sri Lanka, Kenya’s closest competitor is far more successful moving up the value chain and commands higher prices for its tea. Kenya however, has relatively lower production cost, higher labor productivity (2,235kg/ha) and production is growing faster than in Sri Lanka (1,611) and India (1,690) (SOMO; 2007).

Structure

The tea supply chain is comprised of a complex web of actors, producers, collectors, traders/brokers and packers. Tea production has traditionally been associated with large estates or plantations controlled by a handful of multinational companies, but smallholders are becoming increasingly important in the industry as well.

Figure7: Tea Industry Value Chain



Unilever, James Finlay Ltd., and Tata Ltd are three dominant multinational players in the market. They are active in every segment of production and usually carry out the high value added (80% of retail price) (SOMO; 2007) blending, packing and marketing of tea in western countries. This gives them considerable influence on world prices and has led to uneven value distribution along the supply chain. Blending for example means that many tea qualities become interchangeable and can be bought wherever they are cheapest. Companies have considerable leverage over producing countries as they need not rely on any one producing country. Hence while retail prices have remained stable, average auction prices between 2000 and 2005 were around half of those in the eighties. Supported by government, smallholders in Kenya and Sri Lanka produce approximately 65 and 62% of total production respectively. Smallholders are generally price takers and sell their green leaves to collectors, plantations or processor. Key challenges in the in the smallholder subsector include: low farm gate prices, poor extension services, limited market channels, poor access to credit and low level of farmer organization.

Industry Challenges and Progress

Global tea production cost are high owing to high power tariffs, increasingly high labor costs, expensive inputs like fertilizers, machinery and packaging materials, and poor infrastructure in producing countries. Rising production costs, falling prices, and increased competition among producing countries are driving the restructuring process in the tea industry. These changes have important implications for competition as it relates to the traditional structure of the industry (SOMO; 2007). The estate model in India for example has been abandoned owing to its burdensome and costly labor laws. The smallholder model has become increasingly popular in all producing countries.² Production cost on smallholder farms remain relatively lower than estates owing to hidden family costs and the fact that they do not bear any social costs.

Owing to limited regulation, family costs, and use of seasonal labor, smallholder production is seen as increasingly viable as production costs are often lower than for large estates. This is contrary to theory on economies of scale since it would be most advantageous in cutting the cost of production known to agricultural bulk commodity chains. In the tea sector it seems as if there is a contrasting development as tea growing requires little investment and labor intensity greatly affects the cost of production. Hence it is argued that Kenya and Sri Lanka have become more competitive on the world market as a result of increased small holder production (SOMO; 2007). There are concerns around sustainability issues for the industry in two ways. One is that regulation in the subsector is less strict and farming practices less environmentally friendly. As a result, the second issue is that it would be difficult to include these producers in the export-oriented supply chains which would require with increasing quality, social and

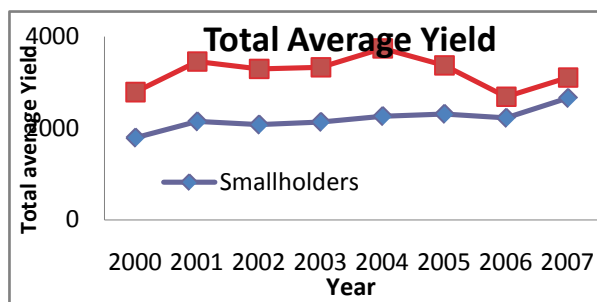
² Except for Malawi.

environmental standards. This is so since the smallholder models also create challenges in terms of lower traceability, quality and continuous supply of tea leaves

History of Kenyan Tea Cluster

Tea is produced in the east and west of the Great Rift Valley. ³Kenya's equatorial climate allows tea growing and harvesting all year round. Kenya is Africa's largest tea producer and tea is its leading export crop. After India, China and Sri Lanka Kenya is the fourth largest producer of black tea of which it produces 369 Million kilograms in 2007.

Figure 8: Total Average Yield



Sixty two percent or 229 million kilograms was produced by the small holder subsector, while 38% or 140 million by plantation/ estates owned by multinational companies. This accounts

for 10 percent of world production and 22% of world exports. Over 3 million Kenyans or about 10 percent of its population is involved directly or indirectly in its tea cluster. There are between 400,000-500,000 registered tea growers in Kenya, 93 registered tea factories, 12 brokers and 100 buyers in Kenya (TEA EXPO MACAO 2008).

Since 2003 there has been increasing output of tea in Kenya. This is partly attributed to increased land use in Kenya. Large growers have generally produced higher average yields than small holders.

³ It is ideal for these crops given the higher altitude (1,500-2,700 metres above sea Level), rich tropical volcanic red soils, and well distributed rainfall (1200 mm to 1400 mm per annum).

Origin of Kenya Tea Cluster

The Kenyan Tea cluster originates from a colonial legacy independent from local demand. Tea was introduced into Kenya from India in 1903. However the first commercial planting did not occur until 1920. Traditional tea varieties include Assam – *C Sinensis variety Assamica* (Masters) Kitamura and Darjeeling.⁴ Kenya tea production was initially developed as colonial export crop by the British company Brooke Bond which was later acquired by Unilever in 1983. Between 1920 and 1939 Brooke Bond controlled all key stages of production, marketing and distribution of Kenyan tea. At the end of World War II, Kenyans initiated their demands for independence from Britain. In 1954 the Swynnerton Plan was introduced to quell independence demands for land redistribution through more “inclusive” participation of African Farmers in the production of the country’s main export crop. They were incorporated through small holder schemes or *Shambas*, with assistance by private companies such as Brook Bond in production processing and marketing of tea (Dinham et al; 1984). The plan allowed for limited participation by Kenyans in the production of tea, coffee, pineapples and other crops.

The Plan also required private companies to participate in these schemes by assisting with the production, processing and marketing of the crop. Brook Bond was a major participant in these schemes, offered training to small farmers ensuring its production went for export markets while small holder tea remained for domestic consumption. This was largely accomplished by setting production quality standards and providing agricultural extension services to small farmers who initially sold their leaf to the large operators (Dinham et al; 1984).

⁴ Today there are some amounts organic oolong and organic teas.

Between 1947 and 1960 Brook Bond was able to increase quality and labor productivity by sponsoring research for higher yielding varieties, processing techniques to improve tea quality and introducing new plucking techniques. These advancements were realized at the Tea Research Institute which was established by the company at Kericho. While this was not intended to benefit smallholders directly the company had considerable influence on how small holder production developed. The Swynnerton Plan was seen as a political and business success as it took political pressure off the companies (allowing them to keep their plantations) while ensuring access to high quality tea production from small holders (Dinham et al; 1984).

In 1963 Kenya gained independence after a bloody struggle. A major feature of this struggle centered on black Kenyans demands to retrieve land from white owned highland estates. With independence white owned land was redistributed to African Kenyans through loans provided by the World Bank and the Commonwealth Development Corporation (Dinham et al; 1984). In the end however the amount of land that could be purchased through this scheme was not significant enough to equalize distribution. This remains a marked feature of Kenya's economy today.

After independence the government continued to steer development of the cluster by supporting the integration of small holders into the mainstream of tea growing. This was accomplished through the establishment of the Kenya Tea Development Authority in 1964 to protect and support small holders and steer the development of a niche for small holders in international tea markets. The KTDA quickly began to build state-owned tea factories which bought green tea leaf from the farmers and controlled the processing and marketing of this. In this way, the KTDA began to steer development towards

establishing a niche for small holders in international tea markets that operate through auctions held in Mombassa and London. KTDA also provided administrative support, agricultural extension services, and quality control support to small farmers which were largely financed by international aid.

In 2000 with increasing pressure through World Bank Structural Adjustment program, KTDA was privatized to improve efficiency and management of tea production and marketing of green leaf.⁵ However, by 2006 there were calls within the Kenyan calling for the renationalization of KTDA. Supporters for re-nationalization argue that KTDA managers were not responsive to dynamics of the industry, and allowed benefits to middlemen at the expense of small farmers, and that while tea earns premium in revenue for the state, farmers get nothing in return due to unsound. Those opposed argue that the recent wind fall earning is testimony to the effectiveness of the Agency and any move to roll back authority to the government will spell doom for the industry. In 2008 the Kenya Tea Industry Task Force, commissioned to look into the issue, released its report (allafrica.com;2008).

The Kenyan Tea Cluster: Overview

Historical Cluster Performance

The tea industry is one of the greatest successes in Kenyan agriculture. Tea planting and production have expanded rapidly since independence in 1963, from 18,000 tonnes and 24,448 hectares in 1963 to 370,000 tonnes and 149,000 hectares in 2007 (KNBS and TBA). The increase in production could be explained partly by favourable weather

⁵ It was renamed the Kenya Tea Development Agency as opposed to the the Kenya Tea Development Authority.

pattern, early involvement of multinational tea companies, and the increase in the total area of land under cultivation.

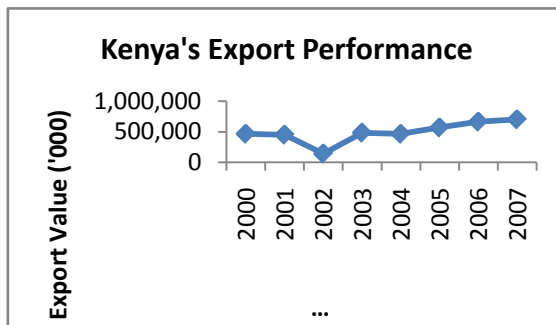
Small holders have continued to dominate production producing, on average, about 60% of total output. (Kenya National Bureau of Statistics and Tea Board of Kenya). However, the average yield per hectare is higher in large estates than smallholder farms largely because of better use of technology, inputs, and economies of scale. New ways must therefore be found to increase the volume and value of productivity in smallholder farms.

Export Performance

Tea is the leading agriculture export in Kenya. On average, it contributes 28% of the value of total agricultural exports, followed by horticulture (20%), fish (9%) and coffee (4.2%), and others (38.8%). (KNBS). The main buyers of Kenyan tea are Pakistan, the United Kingdom, Egypt and Yemen, accounting more than 70% of Kenyan Tea export. Pakistan alone imports 23% of the total tea export ((EPZA, 2005). Over-reliance on a few key export markets has been one of the major challenges of the Kenya Tea cluster.

The risk of this overreliance was underlined by Pakistan's recent decision to reduce its tea imports from Kenya (Business Daily Africa; 2008). Kenya exported 98 million kilograms of tea worth Sh. 12 billion to Pakistan in 2005, but this gradually shrunk to 80 million kilograms worth Sh. 10 billion in 2007. The declining market share can be traced to a decision by Pakistan to enter into Free Trade Agreement (FTA) with India and Sri Lanka in the framework of the South Asian Association for Regional Cooperation (SAARC).

Figure 9: Export Performance



Source: UN Comtrade database

In part to address the market access erosion the Kenya Tea Board (KTB) and other players in the industry are exploring new markets in West Africa, North Africa apart from Egypt, Middle East and Eastern

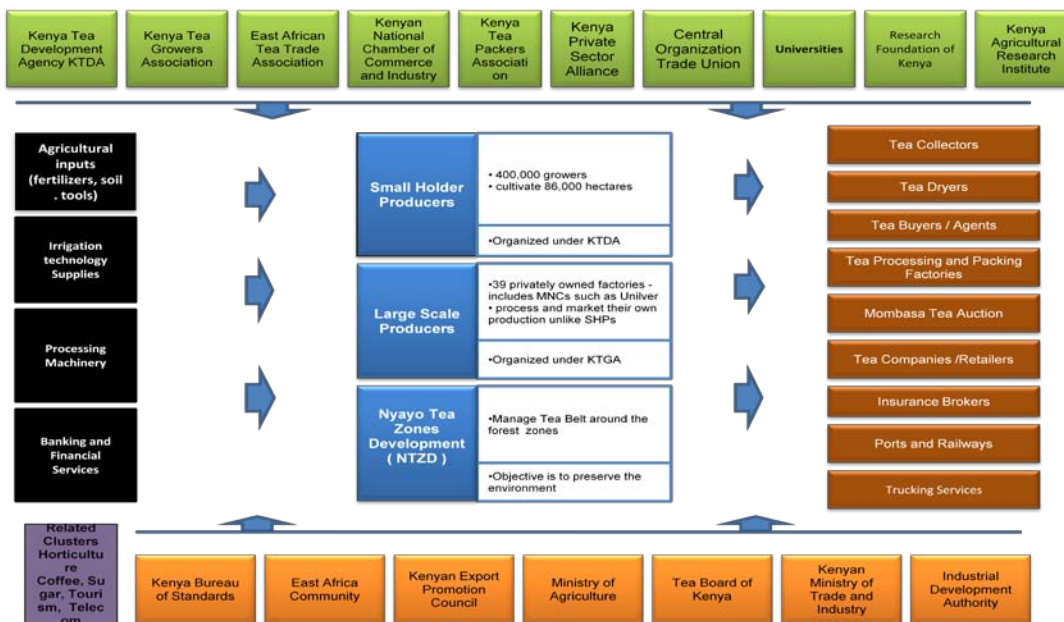
Europe (EPZA;2005 and NES;2003).

Traditionally, Kenyan black tea has been sold in bulk. However it is widely sought after by leading tea blenders to create some of the most respected global tea brands. The role of value addition in Kenyan tea export is very limited. UK and Germany are not among the top tea producers in the world; yet these two countries are still key players in the world tea export market generating up to 50% of Kenya export earning by adding value to tea (FAOSTAT;2008). By contrast, Kenyan farmers export semi-processed, low value produce. The limited ability to add value and high production cost makes Kenyan tea export less competitive in global markets. In short, one of the major constraints to tea production in Kenya is the limited processing capacity. Kenya should therefore adopt policies that will enable it to capture a greater percentage of value added than at present. Encouraged by the TBK, there is an emerging value-added sub-sector, led by the Tea Packers Association, which aims to provide consumers worldwide with pure Kenyan branded teas, blended at source (EPZA, 2005). One examples of this include an agreement with the Tea Kenya Packers Association (KTP) and Tabai of the USA which will secure 10% of the US market for Kenyan tea. Another is an Agreement by KTDA and Safai Tea Canada that will market tea in Canada using Canadian technology for production and value added (Gesimba et al: 2005).

Mapping the Kenyan Tea Cluster

Kenya has a relatively developed Tea Cluster. It includes a wide range of competing small- holder and multinational producers, suppliers, value adding firms, IFCs and regulatory agencies. The tea sub-sector is therefore well organized with different sector players having various roles complementing and at times overlapping each other.

Figure 10: Kenya Tea Cluster Map



Institution for Collaboration

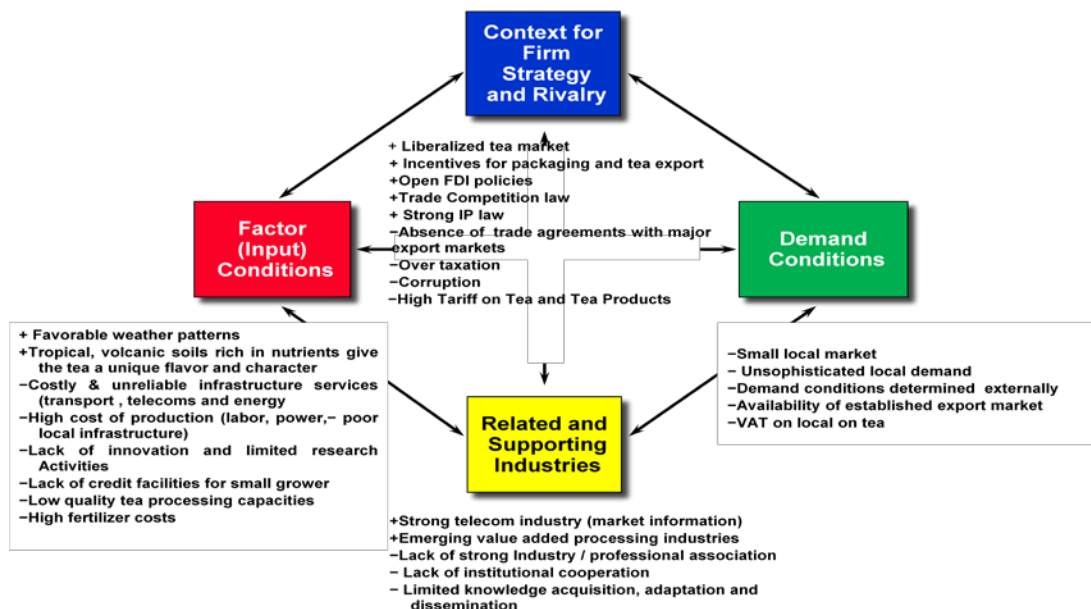
Other organizations playing important roles in Kenyan Tea Cluster include East Africa Tea Trade Association (EATTA), the Kenyan Export Promotion Council (EPC), the Kenya National Chamber of Commerce and Industry (KNCCI), and KTP. EATTA brings together tea producers, brokers, buyers and packers and is the auspices under which the Mombasa Tea Auction is conducted. The Export Promotion Council (EPC), established in 1992, has the mandate to promote and develop Kenya's export activities.

The Kenya Tea Cluster Diamond

The success of the Kenyan tea cluster is mainly driven mainly by factor conditions and further enhanced by the Context for Firm Strategy and Rivalry (CSR) factors. The history

of the cluster reveals the importance of the natural factor advantages, such as perfect climate, fairly good port infrastructure and some good knowledge of tea cultivation. Later, other parts of the diamond came into play. An open foreign direct investment (FDI) policy in terms of CSR factors encourages multinational to engage in the tea sector and take advantage of the established export market. Slowly, several new organization for collaborations emerged. Of course, the four areas of the business environment as shown below are self-reinforcing and act as a system. Weakness in any part of the business environment, then, can erode the competitiveness of the cluster. In the Kenyan tea cluster, the weakness of demand conditions significantly eroded the competitiveness of the cluster.

Figure 11: The Kenyan Tea Cluster Diamond



Context for Firm Strategy and Rivalry

Kenyan economic policies are generally based on open market principles that protect intellectual property rights, encourage investment and promote free trade. Kenya's open

FDI policy allows foreign tea companies to own businesses in Kenya. Kenya has also signed a number of bilateral treaties for promoting and protecting FDI. This openness permits inflow of skilled people, investments, and new technology into the economy and tea cluster. Kenya has also put in place a new IP law with strengthened enforcement measures. Moreover, the country is a signatory to various treaties under World Intellectual Property Organization (WIPO) which enabled Kenya to fortify its intellectual property right protection. Kenya's Competition regulation encourages competition by prohibiting restrictive trade practices. Together these factors have positive impact on productivity and competitiveness.

Kenya maintains generous incentives for processing and packaging tea. They include VAT exemptions, a ten year corporate, income and withholding tax holiday and high quality infrastructure. Kenya's Export Processing Zone (EPZ) offers additional incentives particularly to export oriented investors. However, over taxation is a significant issue in Kenya. The government imposes a wide range of levies, fees on inputs, production and services used by the cluster. The import tariff on tea and tea products for example has risen from 15% in 1999 to 25 % today (WTO; 2006).

Factor Conditions

Competitiveness depends on the presence of basic factor conditions. On the positive side, the Great Rift Valley Region of Kenya provides an ideal climate for tea growing. However, the production costs are very high owing to high power tariffs, high labor cost in large scale producers (arising from negotiated wages with trade unions), expensive inputs such as fertilizers, machineries, packaging materials, poor local infrastructure, and inefficient market structure (particularly for small holders). In Kenyan tea estates have

identified the high cost of labor as their key challenges in managing production costs. Labor cost has risen from 43 percent in 1999 to 55 percent in 2006. Comparatively, this cost has increased out of step with the inflation rate. While wages rose 174 percent inflation rose 70 percent between 1996 and 2007 (WTO;2006). Limited research activities in the cluster also inhibit productivity. The little research takes place in the agriculture sector is not effectively used due to lack of prioritization and coordination among different research institutions. Moreover, research is mainly financed through donor support; domestic funding represents less than .01% of government budget.⁶ Access to bank credit is still a major problem for smallholders partly due to the limited use of land as collateral (WTO; 2006). The high cost of agricultural inputs, largely due to lack of competition, has also led farmers to substantially reduce their use of quality inputs, such as seed, fertilizer, and pesticides.

Demand Conditions

The local market for tea is small. Only 5% of the Kenyan tea production is consumed locally. In 2008, 17.5 million kilos of tea were consumed locally compared to the 345 million kilos of tea the country produced (Daily Nation;2009). In addition unsophisticated local demand implies that there is no critical customer base in the country that pressure local firms to improve the quality and variety of tea and offer new insights into existing and future customer needs. The high tariff on tea and tea products further inhibits competition in the home market. Inadequate national packaging standard is also another factor that explains the lack of sophistication of the local market. Kenya however, facilitated by large growers, enjoys an established export market in unprocessed black tea.

Related and Supporting Industries

The cluster has many IFCs and a full-blown cluster map has emerged. For example, the Mombasa Tea Auction, the second largest tea auction in the world, is indicative of the importance of Kenya as a major global tea exporter. However, there is limited cooperation, exchange of information, inter-firms linkages among small growers and multinationals, suppliers and supporting institutions. Lack of coordination among industry associations, chamber of commerce and supporting institutions leaves some issues unattended and other areas duplicated.

Strategic Issues

Strategic Challenges

An analysis of the cluster points to a wide range of challenges which we attempted to prioritize and sequence in five strategic categories. First, the high cost of production of tea in Kenya inhibits the productivity of the cluster. The cost of producing tea is very high and producers barely break even. The Standard newspaper (August 28, 2008), for example, reported that many small-scale growers uprooted their tea plantation due to rising cost and lack of credit facilities. Second, Kenya is highly dependent on a few export markets and types of teas. Recently, Pakistan, the single biggest buyer of Kenya tea, has concluded a FTA with India and Sri Lanka, eroding Kenya's market share considerably thereby. The third strategic challenge is lack of innovation and development momentum in the cluster. There is a path dependency problem where the cluster is locked into exporting only unprocessed black tea. Fourth, like most clusters, the Kenyan Tea cluster has a number of IFCs. However, there is a weak link and co-ordination among businesses, professional associations, and knowledge institutions. Finally, the

productivity and competitiveness of the Kenyan tea cluster is inhibited by weak local marketing and limited value adding.

Current Government Strategies

The Kenya government has taken a number of steps to improve the competitiveness of the economy and the cluster. In 2007, the President of Kenya, Mwai Kibaki, unveiled “Kenya Vision 2030”. The goal of Kenya Vision 2030 is to transform Kenya into industrializing middle-income nation by the year 2030. At the sector level, two policy strategies have significant impact on the tea cluster. The first is the Strategy for Revitalizing Agriculture (SRA) 2004-14 unveiled in 2008. Its objective is to transform agriculture into a profitable, commercially oriented, and competitive sector. The second is related to Kenya’s the 2003-2008 National Export Strategy (NES). The Strategy aims to improve Kenya's export performance by deepening existing export markets, opening new markets, diversifying the export base away from reliance on traditional exports, enhancing market access, and strengthening institutional support networks through trade facilitation and enhancing competitiveness. The tea and coffee clusters are among the fourteen priority sectors identified in the NES.

POLICY RECOMMENDATION

Until recently, the story of the cluster is one of an early success, emergence of local and foreign large-scale producers and subsequent large expansion of production and export of unprocessed tea. The Kenyan Tea cluster is now at a critical stage where profits might decline unless the producers focus on innovation, quality improvement and value adding.

Cluster Vision

In order for the cluster to grow and prosper, Kenya will require: developing demand sophistication (for example, marketing tea as a lifestyle beverage for Kenyan youth); improving yield and quality of tea (for example through improved seed and genetic seed improvement and pest and disease control); product differentiation (through blending see honest tea, organic tea and fair trade tea), value adding (processing, blending and packaging); developing strategies of competition and cooperation among all the cluster participants; and institutional conditions favouring innovation and change. Our vision for the tea cluster is to *be a high- yield, highly differentiated, value added* tea cluster. It competes globally by continuously improving quality through innovation, differentiating tea variety, and adding value instead of merely expanding quantity and reducing price.

Constraint	Recommendations	Approach	Actors
Cost of production	1. Review all taxes on production, inputs, and services used by the tea cluster and adopt less-distortionary approaches of taxation such as taxing income.	Priority: medium Feasibility: High	Government of Kenya (GoK)
	2. Improve the efficiency of Agricultural inputs marketing system, for example, by addressing a procurement and supply management.	Priority: High Feasibility: High	GoK and Input Suppliers
	3. To ease the problem of credit for smallholders, encourage micro-finance institutions to set up operations in rural areas.	Priority: High Feasibility: High	GoK and Supporting Institutions
	4. Increase R&D spending to the tea cluster and enhance collaboration among existing agricultural research institutions as the ultimate source of productivity is innovation.	Priority: High Feasibility: High	GoK and Research Institutions

Reliance on a few markets	<p>1.Negotiate a South-South Preferential Trade Agreements with Pakistan and India to maintain the current generous market access in these countries.</p> <p>2. Promote new non-traditional tea markets.</p> <p>3. Pursue a strategy of differentiating Kenyan tea.</p> <p>-Initiate a Geographical Indication (GI) and trademark protection efforts for Kenya's unique and popular tea varieties. This could be targeted to the growing environmental conscious consumers in the North by differentiating its tea production process as younger and purer bushes that uses less pesticides that its competitors.</p> <p>-Brand and promote its unique tea by emulating the success of the Kenya Tourism Cluster (the success of which has been</p> <p>-Provide more effective incentives for value addition, blending, packaging and increasing tea varieties. Ultimately, the key for the competitiveness of the Kenya tea cluster is not simply cost but quality and uniqueness of variety.</p>	<p>Priority: High Feasibility: depends on willingness of Kenya's trading partners</p> <p>Priority: High Feasibility: High</p> <p>Priority: High Feasibility: High</p>	<p>GoK</p> <p>Tea Board of Kenya, IFCs, Kenya Export Promotions</p>
Weak domestic markets	<p>1. Eliminate the 25% tariff on tea and tea products \Provide incentives for domestic promotion efforts</p> <p>2. Educate the public on health benefits and diversify tea products</p> <p>3.Sponsor independent tea testing, product certification, and rating services and</p> <p>4. Adopt and adapt international packaging standards.</p>	<p>Priority: High Feasibility: High</p>	<p>GoK, IFCs, Media</p>
Lack of innovation momentum	<p>1.Develop shared understanding and commitment about innovation.</p> <p>2.In order to address the problem of fragmented R&D efforts for new tea varieties and avoid duplications of research, business and research organisations need to enhance collaboration.</p> <p>3. In addition, firms should increase their R&D spending</p>		<p>All cluster participants</p>
Poor coordinat'n among IFCs	<p>1. Establish a new, overarching institutional platform of the Kenyan tea cluster participants under a strong and motivated leadership.</p> <p>2. Enhance membership to cover all the players in the value chain.</p> <p>3. Enhance its activities by, among other things, assisting in information gathering, developing new tea varieties, carrying out market studies and more broadly helping transform all the players into complementary and high performing entities.</p>	<p>Priority: High Feasibility: High</p>	<p>All IFCS</p>

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