PART 1

Chapter 1

Issues and Analytical Framework of Study on Private Investment behavior in Developing Countries

1.0.0: Introduction:

The material welfare that the citizens of the industrialized world enjoy and which developing countries are striving to achieve revolves around business enterprises that use modern science and technology to produce and exchange goods and services. In these industrialized nations, decisions that are important for economic prosperity, such as investment, employment and output are made largely by private sector enterprises.

In their continuing development efforts toward attaining high levels of living standards, developing countries began serious economic reforms in 1980's under the guidance of the World Bank and IMF. Generally, the new policies present a critical view on the effectiveness of state interventions in the economy and emphasize market solutions, increased role for the private sector and integration in the global economy. However, despite more than a decade and a half of reforms, economic performance in most developing countries (especially in Africa) remains disappointing. Economic growth as measured by growth in real GDP has stagnated and in many countries private investment has fallen. Since the new orthodoxy emphasize the private sector as the engine of growth, a robust response in private investment is essential if long-term growth is not to be jeopardized in reforming countries (Serven and Solimano, 1993). The importance of investment cannot be overemphasized. Investment expenditure determines the rate at which a nation increases its stock of capital, determining long-run growth and productivity. Apart from

being a major component of aggregate demand, investment is necessary in the application of new ideas, such as new production techniques.

Kenya has been able to invest an average of about 23 percent of its GDP over the period 1972-1996. Although this compares well with other countries in sub-Saharan Africa, it's below the level recorded by the NIC's[1]. Nevertheless, since early 1980's investment activity has declined. Investment activity recovered slightly after 1992 but this still remain below the levels recorded in the 1970's. Chart 1.1 below shows movements in gross domestic investment as well as savings over the period 1964-1994. The dismal performance in both private and public investment can be seen in Chart 1.2. Table 1.2 (in the statistical appendix) shows movements in public and private fixed investment, foreign direct investment and net private foreign capital inflows over the period 1975-1996, all have registered declining trends.

Much research has been carried out on the effects of the World Bank and IMF sponsored economic reforms on investment in developing countries. Both at a theoretical and empirical level, various aspects of economic adjustment policies have been analyzed. Among these are; the effects of exchange rate adjustments, fiscal adjustment, external debt, financial policy reforms and instability and policy uncertainty arising out of reforms. An important aspect of these studies is the attempt to capture developing countries' specific issues, which do not feature in literature on private investment in the industrialized countries. However, despite these improvements, these studies suffer two important limitations. One, there is little or no reference to socio-political factors, such as, the relationship between the government and business enterprises. Secondly, in the study of private investment, mainstream neoclassical economists take the private sector as given. The capacity of the investing private sector enterprises to meet

[1]For example, over the period 1982-1992, Korea invested about 31.3, Singapore 38.4, Malaysia 31 and Indonesia 27.9 percent of their GDP

the material welfare of the people domiciled within a given region is supernumerary. The firm is treated as 'a box into which inputs are entered at one end and out of which outputs are produced at the other end' (Sawyer, 1989: page 124).

It is recognized that investment expenditure cannot continue without prospects for profitability, consequently the basic approach in the economic reforms has been a strong emphasis on creating a favorable environment for private sector enterprises, whereby pecuniary benefits can be assured. Some political economists, such as Veblen (1904) have questioned whether the material interests of the populace coincide with 'the pecuniary interests' of businesses. "This persuasion is an article of popular metaphysics, in that it rests on an uncritically assumed solidarity of interests, rather than an insight into the relation of business enterprise to the material welfare of those classes who are not primarily business men" (Veblen 1904, page 286). In a private sector driven economy, it is the private business enterprises that play an important role determining the standard of living of the people. Consequently, it would be of interest to analyze the economic performance of nation from the point of view of the capacity and nature of firms operating in the given country. Joseph Schumpeter (1934) described an entrepreneur as the 'fundamental phenomenon of economic development'. Although in industrialized nations, large corporations and conglomerates have replaced the individual entrepreneur, this transformation has not changed the central importance of the business enterprise. The firm centered approach to development is enjoying a comeback. Chandler and Hikino (1990) describes the economic growth and transformation of the three leading industrial nations - Germany, Great Britain and the United states in terms of the evolution of firms operating in these nations. According to Chandler, the modern industrial enterprise in these countries 'had been rural, agrarian, commercial; they became

industrial and urban. That transformation, in turn, brought about the most rapid economic growth in the history of mankind' (Chandler 1990, page 3). Although the study is given in an historical context, it gives important insight on the evolution and relationship between these firms, government and the educational system. Porter (1990) has also used a firm-based approach to develop the theory of *The Competitive Advantage of Nations* . He underscores the importance of firms. In Porter's words, "Sustained productivity requires that an economy continually *upgrades* itself. A *nations' firms* must relentlessly improve productivity in existing industries by raising product quality, adding desirable features, improving product technology or boosting production efficiency" (1990: page 6; italics my own). Other firm centered approaches to development include; Hollingsworth et al (1994). On newly industrializing nations of East Asia, Hobday (1995) has developed the idea of latecomer firm. Perhaps, the central idea in the firm-centered approaches to development is that national economic performance is the 'collective performance' of individual firms and as a result, differences in economic growth among nations can not be explained without reference to business enterprises , their effects and the factors that impact on them. For example, the economic growth of countries like Germany can not be explained without reference to enterprises such as Siemens A.G., or the growth of Japan without reference to companies like Mitsubishi, Hitachi, Toyota e.t.c, or the rapid ascend of Korea in relation to the industrial groups such as Daewoo, Samsung, Hyundai e.t.c or the US with reference to enterprises such as IBM, General Electric (GE), AT&T e.t.c

If private investment is studied in relation to its contribution to material welfare and long run growth of the economy, it is important to consider the nature and capacity of the business sector. The purpose of this dissertation is to offer an approach to the study of private investment, which is more comprehensive in that it goes beyond the existing mathematical

models of investment functions that are limited to a few variables and constrained by data limitations. Drawing on the ideas of physiocrats, Veblen (1904) and Porter (1990) and institutional economics, our main contribution is to discuss a theory of investment that recognizes the importance of institutions, nature of businesses and direction of investment expenditure in determining long run growth. Most theories of private investment look solely at the cost of factors of production or profitability of production and how different policies affect them. The institutional conditions under which investment takes place are not given adequate attention. Our approach to the study of private investment is twofold; the first part of the dissertation discusses investment from an political economy point of view (on grounds that economic issues can not be separated from socio-political issues), emphasizing the institutional environment, direction of flow of investment and emphasizing improvement and innovation as the central element of investment in a developing economy. The second part discusses investment from the conventional point of view, drawing on the neoclassical and post-Keynesian theories of investment and making some adjustments to fit Kenyan specific circumstances. This second part is mostly quantitative and thus concentrates on empirical issues to explain the observed performance in private investment. Basically it concentrates on quantifiable public economic policy issues, profitability and aggregate demand.

1.0.1: The Structure of the Paper

This paper is organized as follows. Chapter one is composed of five main sections. Section 1 is introduction. Section 2 discusses a general theory of wealth formation and distribution through economic exchanges in 'a mixed' economic system, highlighting the importance of institutions and direction of investment. Section 3 raises the research issues for study. In section 4, we present an economic survey of Kenyan economy relevant to the

understanding of private investment behavior. Section 5 discusses the development of the private sector in Kenya highlighting the relevant institutional and as well as economic problems. Part 2 of the study begins with Chapter 2. It starts by discussing the existing theories of investment and their relevance to developing countries. In chapter 3, we carry out empirical analysis involving the application of the existing theories of investment, modified to incorporate developing country specific issues. From the discussions in chapter 1 , the financial system is one the basic pillars of the economic system that supports investment. Chapter 4, therefore discusses the importance of this sector in relation to the recent theories of financial liberalization. We emphasize the importance of demand factors and willingness of banks to lend taking into account that supply of funds may be a constraint to the effective performance of the financial enterprises. In chapter 5, we construct a macroeconomic model to analyze the direct and indirect effects of public policy on private investment activity. Using a computer simulation model of the Kenyan macro economy, we attempt to analyze 'crowding out' and complementary hypotheses. In the theoretical framework we assume that the role of the state, among other things, is to ensure macroeconomic stability. Chapter six investigates the importance of macroeconomic policies in explaining cross-country differences in investment. The countries considered are exclusively from Sub-Saharan Africa. Chapter seven, constitute the summary and conclusions presenting the issues for possible future study.

1.1.0: Economic System, national Wealth and Private Investment

The economic system discussed here is 'a mixed' economic system, that is, where decisions on the allocation of resources are made by both the government and the private sector. The western industrialized nations as well as most developing countries, like Kenya are mixed economies thus of interest for study. The basic unit of discussion is the business enterprise or firm. The discussion of the firm here is different from what is taught in mainstream economics textbooks such as theories of perfect competition, monopoly, oligopoly, monopsony and monopolistic competition, which discuss firm behavior on the basis of price and output determination. Since the purposes of this study is to understand the significance of the investment activities of the firm for the economy and society as a whole, we treat a firm as a unit of a social organization. This approach is not novel. Many studies that explore the relationship between the state and economy implicitly study business enterprises within the context of a social organization.

As far as we know, the physiocrats were the first to suggest the existence of a natural order in economics that allowed people to become prosperous, without need for direction from the state. One of the leading physiocrats, François Quesnay, traced how wealth passed from one class of the society to another, a flow he found to be circular and self-sustaining (Gide and Rist, 1915). Quesnay's analysis rested on the division of the society in three social classes: A productive class consisting mainly agriculturists 'and perhaps also' fishermen and miners; A proprietary class, consisting of landed proprietors and those supported by them; A sterile class, constituting the rest of the population. According to the physiocrats, all exchanges were thought unproductive. Although Adam Smith, had a view of creation of wealth as a series of joint undertakings engineered by various sections of the society and linked together by the tie of

exchange.. All equally indispensable' (ibid pp. 61), (Smith) like the physiocrats drew a distinction between productive and unproductive works. According to Adam Smith, all services comprising domestic servants, administrators and magistrates, soldiers and priests, musicians, artists were classed together as 'immaterial products'. As concerns general interest, Smith held the view that investment of capital in agriculture should come first, in the second place industry and finally trade. Continuing with the recognition that some activities or groups in an economy are key to economic prosperity, List (1856) argued that a nation should concern itself with the 'productive forces'. According to List these include; moral and political institutions, and manufactures. The debate on development priorities did not end with these classical ideas. In light of the rapid development of Asian economies, this debate has been revisited. Basically the debate is between those who argue that the state should pursue a generalized policy and those in favor of selective industrial policy (Wade, 1990, 1992, World Bank, 1993).

On the basis of the above observations, our theoretical framework on the formation and flow of wealth between different groups of society, should be seen from 'a leading sector' (or simply, some activities are more important for national prosperity) point of view. Treating firms as units of social organization, we conveniently group business enterprises in three broad groups: production, trade (investing in goods as they move from producer to consumer) and financial services[2]. The above institutions constitute the naturalism of classical economists that may lead to prosperity without outside intervention[3]. In an often-quoted phrase, according to

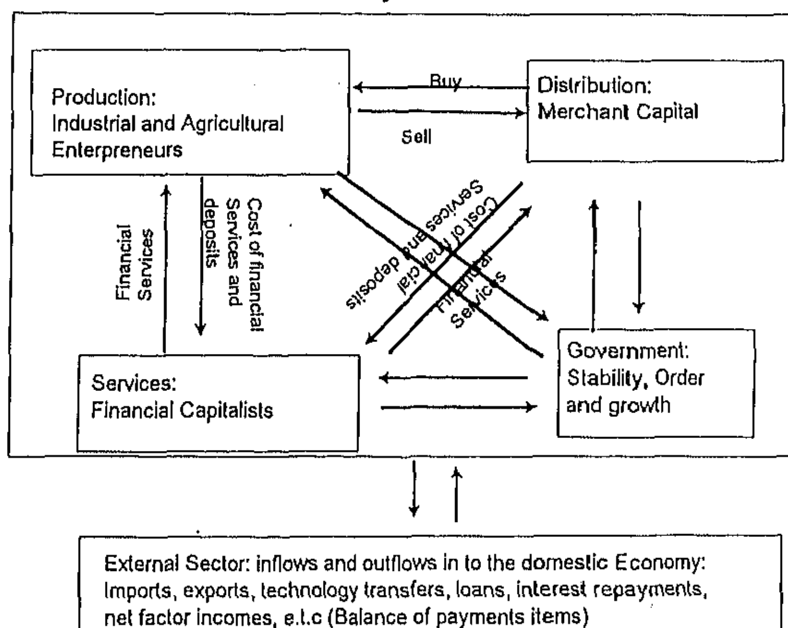
[2]There are other service activities such as; food service; leisure; travel related; general businesses services such as accounting, cleaning, advertisement; and transport. These are important business activities through which resources for investment and or reinvestment may be generated and whose services are important inputs in aiding production. The basic assumption is that, the growth of these businesses may be highly related to what is happening in production. Some of these activities come about to support 'productive' activities. In an economy there are also landed proprietors who earn rent, for simplicity they are not discussed. The exclusion of these businesses does not alter the overall analysis as long as we assume that their catalyst is in agriculture and industry. For example, rent may be highly related to the commercial value of the property in question.

[3]It should be noted that. Smith argued for some restrictions on the activities of banks (ibid.pp.96)

Adam Smith, these institutions are 'a consequence of a certain propensity in human nature...the propensity to truck, barter and exchange one thing for another' (Smith, Book 1, Vol. 1, 1920, chapter 2, pp. 15). Money, 'the great wheel of circulation' was not a product of public authority. State intervention came much later 'merely to guarantee by means of design the weight and purity of such coins as already in circulation' (Gide and Rist, 1915, pp. 71, Smith, Book 1, Vol. 1, 1920, Chapter IV). The flow of resources between the three groups and the state can be depicted schematically as below;

Figure 1: Formation and Flow of Wealth in a mixed Economic System

Figure 1: Formation and Flow wealth in an A mixed Economic System



Note: The government obtains tax revenue from the three sectors and provides public goods as well as administrative regulations. There is also direct government purchases of goods and services that affect accumulation in the respective sectors

We have identified three broad group of businesses together with the external sector that are vital in the formation and flow of wealth of a nation. The above schematic

presentation should be viewed as a comprehensive process of economic transactions. Under production, we have businesses in agriculture and industry. Agriculture in this case is considered in a broad sense and should include; fishing, forestry, mining and quarrying, and plant and animal husbandry. Those firms involved in these activities are mainly involved in producing the 'crude' product. Industry involves further processing and manufacture of industrial goods. The second group comprise traders or merchants. These are businesses investing on goods that are in transit between the producer and the consumer, they accumulate money and capital through buying and selling. The third group constitute those investing in financial services whom we have referred to as financial capital. Apart from accumulating resources, financial entrepreneurs facilitate the process of accumulation by providing financial services to other entrepreneurs and the government. As mentioned above, the interaction between producers, distributors and financiers and consumers forms a natural order in economics that may not require direction from the state.

The figure above basically represents the capitalists mode of production. This mode of production coexists and interacts with the so called 'informal' sector. This sector which is largely unregulated and unplanned, comprising petty commodity producers, traders and service workers operates beyond state 'regulation' and taxation. In Kenya. there has been increased interest in this sector since the ILO report, *Employment, Incomes and Equality: A Strategy for Increasing Productive Employment in Kenya* of 1972. The interaction (naturalism) described above may be observed in this informal sector too, that is, between informal money lenders (some may be relatives), peasant farmers or *Jua Kali* (in Kenya owners of informal micro-enterprises) and merchants (small retailers (*dukas*) and hawkers - in rural and urban areas). In his account of the development of African businesses in African

Reserves in colonial Kenya, Kitching (1980) notes that the emergency of 'subsistence trade' took the colonial officers by surprise. There are also accounts of pre-colonial trading in Kenya, see for example, Lamphear, (1970) on the Akamba trading region. Some of the activities in these informal sector are simply for economic survival and others combine formal employment with these informal activities to supplement their incomes (Simon, 1992, King, 1996). These basically underscores the apparent spontaneity of these enterprises. In developing economies, there is a constant desire to capture this sector for taxation purposes. Lewis (1954) has discussed in his *Surplus Labor Model* how the modern capitalist sector may benefit by absorbing surplus labor from this sector at subsistence wage. However, in most Sub - Saharan Africa, growth in the modern capitalist sector has not been able to absorb peasant labor resulting in a growing army of unemployed, who further contribute to the expansion of the informal 'survival' activities. However, within these informal sector, there are small scale activities which have the potential for growth and upgrading (ILO, 1995).

As explained above, in a mixed economy, resources are allocated through a combination of both private and public decision making. However, what is the appropriate balance between public and private sector activities is still a controversial issue. For example, the World Bank has made clear its position on the role of the state summed up as 'market friendly' (World Development Report, 1991). According to the report: "........intervene reluctantly: Let markets work unless it is demonstrably better to step in. Certain actions usually pass this test in principle because the private sector does not usually carry them out: spending on basic education, infrastructure, the relief of poverty, population control and environmental protection. Certain other actions usually fail the test. For instance, it is usually a mistake for the state to carry out physical production, or to protect the domestic production of

a good that can be imported cheaply and whose local production offers few spill-over benefits" (World Development Report, 1991, Page 5). According to Wade (1990), the list of the functions of the state in the neoclassical orthodoxy becomes controversial when it comes to recognizing market failures, such as may occur in technological development, personnel training and incomplete markets. Market failures may arise in three major ways: The forces of demand and supply may not provide an acceptable distribution of income. Thus some economists have argued that the government has a role in the redistribution of income. Markets may also be prone to periodic episodes of high unemployment and prices. The state thus has a role in the stabilization of the economy. There are also market failures that may arise due to externalities. That is when an individual firm takes an action, others bare the consequences. One of the most common negative externality is pollution. Public goods are an example of positive externality goods which if left to the private sector alone, they may be under-supplied or because of their nature (non-excludable and non-rivalrous), they may not profitable for private production. These may include defense, law and order, and basic infrastructure like roads, education and health services. In industrialized nations, the state is also involved in extensive transfer payments; such as unemployment benefits, pension e.t.c. Nevertheless, the debate on the appropriate role of the government still goes on. On the United States, Stiglitz (1993) observes that "while some claim that the presently perceived problems are the result of, or are at least exacerbated by, government programs, others believe that the main problem is too little government, or misdirected government programs" page 191. On Japan and the other newly industrialized nations of Asia, the debate has not been settled. In the interpretation of the post war phenomenal growth of Japan there have been two perspectives one emphasizing bureaucratic regulation or developmental government and the

other emphasizing market forces (Friedman 1988). It is not our purpose here to contribute to this 'appropriate size' of government debate but only to offer insights on the role of the state, in relation to private sector investment.

In the schematic presentation above, the external sector is included to account for an open economic system. The external sector affects the accumulation of money and wealth in various ways. The main items are the balance of payments transaction such as imports and exports, net foreign direct investment, net financial inflows, technological transfers, repayments on external debt and net factor incomes from abroad. Foreign trade is important in the process of wealth creation, part of domestic output is exported to the rest of the world. For developing countries, imports of machinery and technology are important in enhancing domestic production. Foreign borrowing, aid and investment are important sources of money and wealth creation for a developing country. In many African countries, excess borrowing has become a problem in the sense that, apart from exports falling short of imports, outflows (in terms of loan repayments and repatriation of business incomes) exceed new inflows, resulting in a net outflow of resources.

The interaction between government and the financial sector has received a lot of attention under the structural adjustment programs by World Bank and IMF. Basically financial liberalization has been seen as necessary to achieve faster growth where there is 'financial repression'. The important characteristics of 'financial repression' according to the proponents of financial liberalization include: regulation of interest rates, credit ceilings and compulsory reserve requirements (World Development Report, 1989, ADB Report, 1994). The consequences of financial repression, it has been argued and sometimes empirically confirmed (See for example, on Sub-Saharan Africa: Seek and El Nil, 1993) reduces the flow

of funds to the formal financial sector, distorts allocation of productive financial resources and thus undermines savings investment and growth. Another important, issue about the interaction between government and the financiers, that economists like to point out is 'crowding out'. If the government borrows excessively from the financial sector, the resources available for lending out to producers and merchants will be limited. According to economists, the government is financially 'crowding out' the private sector. These ideas have been integrated in the financial reform policies by the World Bank and IMF. Pervasive controls by the government may create opportunities that promote corruption or rent-seeking. Usually, public servants may manipulate such government authority and create additional red tape and delays that impose additional cost to businesses. This may be worse when corruption arising from such cases is not penalized promptly. If the attention on government vis viz financial sector can be used as a benchmark, we can argue that merchant-producer-government issues have been neglected in the reform agenda. It is sufficient to say that investment in agriculture and industry is more superior from a social point of view, than is investment in merchant activities. This can be justified from the point of view of technological advancement (learning by doing), employment generation, tax base and productivity. The opposite can be said of merchant activities, they create wealth on goods in circulation, they do not have control on the volume and quality of the goods produced. Merchants can not affect the complexity of output in an economy which is necessary to increase the tax base. Productivity, learning by doing, technological advancement is limited. Although all other business enterprises are equally important, this proposition should be looked at from the standpoint of the so called 'key' sector. Perhaps in the second place comes, the stability and growth of the financial enterprises (capital markets system). As much as this prioritization may appear easy to comprehend, as we

discuss later in the chapter, indigenization policy in Kenya turns this line of thought upside and instead puts merchant activities first. We also briefly discus how politics and business practices (may) impede this strategic choice in the context of the Kenyan economy.

An important question is how the schematic presentation in figure 1 above relates to economic well-being. Drawing on the post-Keynesian theory of income distribution (Kaldor, 1957 and Passineti 1962), the link can be can be briefly discussed. The post-Keynesian theory of income distribution, is not a theory about size distribution of income between individuals but distribution of incomes between wages and non wage incomes or property incomes. The latter constitute profits and profits are an important force in driving a market economy. Without profit and prospects for profit, the market economy would be crippled with business closures, layoffs and consequently social strife. In neoclassical microeconomic theory of a firm, it is stated that the objective of a firm is to maximize profits. Even if a firm were to have other objectives such as market share, dislocation of rivals e.t.c, a minimum profit has to be met otherwise the long run survival of the firm can not be guaranteed.

The gross domestic income (Y) in an economy can be dis-aggregated by identifying the types of incomes that are generated in economic activities. These incomes are:

1. Compensation of employees (w): As defined in the United Nations System of Accounts (SNA), it is the sum of wages and salaries, contributions by employers to social security schemes for employees and contributions paid or imputed made by the employers to employees for pension, insurance and family allowances 4.

2. Operating surplus or nonwage incomes (π): The operating surplus as defined here includes; the operating surplus of government enterprises[5] and the operating surplus of all

4For detailed definitions see, United Nations System of National Accounts, Year Books.

[5]In the discussion that follows we do not distinguish between operating surplus of government enterprises and that of private enterprises, on the assumption that the former is insignificant. The dismal performance of public owned enterprises is partly behind the ongoing privatization.

other enterprises (including depreciation). For simplicity, rent accruing to landlords is included in the operating surplus. Consequently, incomes in the economy comprise; wages and the operating surplus.

The flow of these incomes is regulated by the government, through taxes, administrative regulations and transfer payments such as subsidies and pensions. Thus because of the operations of the government, another set of incomes come into play. These are in the form of taxes (TA) less transfers (TR). Generally speaking, in an economy we can thus identify three important incomes: wages, nonwage incomes (profits) and taxes. Wages determine the consumption and thus the welfare of workers and their families. The same can be said to be true for businessmen or property owners and their families in regard to non wage incomes. Ceteris paribus, the amount of tax revenue determines the capacity of the government to provide public goods that enhance the welfare of its citizens. Again recalling our distinction between merchants and producers, production provides more opportunities for tax revenue than is merchant activities. Various levels of value added in the production chain provide opportunities for a government to raise revenue. We can thus sum up incomes in the economy as;

$$w + \pi + TA - TR = Y \quad \text{....} \quad \text{..(1.1)}$$

The above equation can be expressed in terms of 'disposable incomes', by adding transfers and subtracting taxes. Equation (1.1) can thus be rewritten as; $w + \pi \equiv Y + TR - TA$. However, Y,on the right hand side of equation (1.1) can be expressed in terms of expenditure components of total output, that is; consumption, government expenditure (both for general consumption and investment), net exports (exports less imports) and private investment. Thus the equation can be written as;

$$w + \pi \equiv C + I + G + NX + TR - TA^{6} \ldots\ldots\ldots\ldots(1.2)$$

Where C is private consumption, I is private investment, G is public investment plus public consumption expenditure on goods and services and NX is net exports of goods and services.

Equation (1.2) above, can be rearranged to become;

$$\pi \equiv C + I + (G + TR - TA) + NX - w \ldots\ldots\ldots\ldots(1.3)$$

The nonwage incomes π on the left roughly represents, the incomes of entrepreneurs[7], generally all expenditure flows in the economy are identical to entrepreneurs incomes less taxes and wages. Generally, the various components expenditure whether by households or government or firms are incomes for (property owners) businessmen and in relation to their capital form the incentive to invest. Equation 1.3 shows that there are important relationships between incomes of entrepreneurs, wages and the various components of expenditure, net exports and taxation in the economy. The equation (equation 1.3) provides a link between returns to entrepreneurs and flows of expenditures in an economy, $C+I+G$ is the domestic absorption or spending by domestic residents, part of spending by domestic residents falls on foreign produced goods (imports. Note: $NX=X-M$, where M is imports). Exports (X), on the other hand, is the foreign demand for domestic goods. In an open economy, it is thus spending on domestic output $(C+I+G+NX)$ that determines domestic incomes[8]. NX in the above

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[6]The left side of this equation is presented in the simple two class system as in the Marxist class structure of a capitalist system, that is workers and the owners of means of production (capitalists). In developing countries of Africa, as discussed above, there is another group which can be termed as 'intermediate' or the subsistence economy or what Lewis (1954) has referred to as surplus labor sector. In the presentation of national accounts data on only workers and owners of means of production in the modern sector are adequately covered. Usually the activities of the subsistence sector are not well covered because little if any of the output goes to the market. Professor Arthur Lewis (1954), (1958), has given a thorough discussion of the importance of this intermediate sector in relation to capital accumulation and growth. He argues that, the capitalist sector may draw on the surplus labor at subsistence wage, without impairing productivity (in the subsistence sector) because the productivity is near zero. This enables the capitalist sector to expand as profit increases. In Professor Lewis's model, growth in the modern sector may be stunted when wages rise in the subsistence sector.

[7]Data issues in relation to this variable have been discussed in chapter 3.

[8]In a developing country, imports of capital goods are necessary to further production. Imports of capital goods are an input on the production side but in terms of expenditure, they are not part of domestic incomes.

equation is roughly equivalent to the current account balance in the balance of payments, which is in deficit if imports of goods and services exceed exports of goods and services and vice versa. In the balance of payments identities;

$NX = NFI - \Delta R - NFAP$..................................$(1.3a)$.

Where NFI is net foreign inflows (mainly foreign borrowing) , ΔR is change in reserves and $NFAP$ is net factor payments from abroad[9]. The left hand side is in terms of flow of goods whereas the right hand side is in terms of flow of funds. When both sides of 1.3a above are in deficit, there results *a net resource transfer* from a developing country to the rest of the world. A net resource transfer occurs when the current account is in deficit and interest payments on external debt exceed new loans and other inflows so that the economy continues to run down its reserves to meet international obligations. This then presents a general explanation of how external debt would impact on domestic incomes/output. So external debt becomes a serious problem when new inflows of foreign receipts start running short of repayments.

An important contribution to growth in incomes is productivity: both labor and productivity of capital. To achieve this high productivity, firms must be able to boost production efficiency, quality of their products, improve product technology or new combinations. On the other hand the quality of labor should also improve. Productivity and constant improvement are central in *Competitive advantage of Nations theory* advanced by

[9] In Kenya this item has been always negative implying that foreign owned factors of production earn more in Kenya than does Kenya's factors of production abroad. The impact of these transfers on domestic output or investment can be analyzed in terms of expenditure on domestic goods or direct investment. In some countries, *NFAP* is an important item in the national incomes, according to WDR (1996) most investment in China has come from overseas Chinese. In countries like Jordan, Lesotho, Yemen, and the West Bank and Gaza, remittances as a share of GNP range between 10 and 50 percent. Other countries with high remittances include; Bangladesh, Burkina Faso, Egypt, Greece, Jamaica, Malawi, Morocco, Pakistan, Portugal, Sri Lanka, Sudan, and Turkey.

Porters (1990). He identifies four broad stages of national economic development in terms of the industries or firms that are dominant. These stages are factor-driven, investment driven, innovation driven and wealth driven. Firms in a nation upgrade their positions, developing the capability to compete in new segments and new products. When a nations firms fail to innovate and upgrade in terms of quality, features, new products and technology, economic progress is held back. According to Porter, the stages are not distinct but reflect dominant attributes of a nations industry most important for economic prosperity. The theory is more elaborate, what we can do here is to briefly highlight the features at each stage. At factor driven stage, the most important characteristic of industries in a country, is that they are based on abundance of factors: e.g., favorable agricultural conditions for certain crops, mining or semiskilled labor. In the investment-driven stage, firms invest aggressively in modern facilities and best technology. Firms try to master foreign technology and methods and try to develop their own models. At this stage, factors of production are also upgraded. At the innovation-driven stage, firms in a nation not only 'appropriate and improve technology' but 'create them'. The labor is highly skilled and the technology is highly advanced. According to Porter (1990), Japan and Italy entered this stage in 1970's. Upgrading through the first three stages reflect dynamism in the economy. The wealth driven stage leads to decline. In this stage, investment and innovation are stunted. The goals of investors shift to capital preservation with investment in financial assets becoming more important. Britain is given as an example of a nation that has slipped into wealth-driven stage. "Britain illustrates the self-reinforcing downward spiral of the wealth-driven stage. Position lost in one industry has spread to affect others" (Porter, 1990 pp. 573). Chandler and Hikino (1990) echoes Porter's

view, 'British entrepreneurs' failed to 'make the investments and create the organization essential to compete at home and in new industries' (Chandler and Hikino 1990, pp. 285).

In the context of globalization, 'upgrading' for a developing economy can be understood from the point of view of 'shallow integration' and 'deeper integration' (Radosevic, 1999). 'Deeper integration' is characterized by production networks and technology accumulation while 'shallow integration' relates to trade and financial globalization (UNCTAD, 1994). Mcgrew's (1992) characterization of globalization in terms of scope (reach) and intensity (deepening) echoes the two levels of interaction (shallow and deeper integration). Seen from the point of view of figure 1, in terms of volume and value, most developing countries could be seen as 'merchants', without command over production and technology. As Simon (1992) observes Sub-Saharan Africa countries have not been able to transcend there colonial roles as suppliers of agricultural or mineral raw materials and importers of consumer durables and capital goods. Although diversification of high technology production by transnational corporations has been taking place especially into the Newly Industrialized Nations of East Asia, through 'sourcing', subcontracting and OEM's (Original Equipment Manufacturer's), these production networks are virtually absent in most Sub-Saharan Africa.

Perhaps most economists would agree that the upgrading process discussed above is necessary for economic prosperity. However, upgrading of the economy may not be possible without technological progress. Technology here understood from the Institutionalists point of view in broad terms as a problem-solving process. This view distinguishes between 'hard' technology or gadgets/tools and the 'soft' technology or the accumulated skills and knowledge of the society (Gregori, 1980; Dwivedi, 1994). The latter is the basis of the former.

Technology plays an important role in transformation of material resources, lack of it in many developing countries has meant that they should rely on multinational corporations to exploit their resources. According to Veblen (1904) businesses tap the community's technological efficiency for pecuniary benefits. Of course by so doing firms benefit the society in terms of employment, material welfare and the monetary multiplier effects that arise through increased incomes. This being the case, firm or industry upgrading will not be successful without concomitant improvement in the community's technological efficiency. Take for example a motor vehicle firm, it uses knowledge from various fields of engineering, marketing, accounting e.t.c. The development of an automobile over the years to its current state - from the 'horseless' carriage of the 19th century to the automobile of the 21st century draws on the accumulated knowledge of the society, which the business enterprises tap. Where sophisticated production occurs, the society possesses the sophisticated problem solving capability. For example, it would be reckless for a firm to start up a computer production business in a society with a limited level of literacy!!. Or the huge financial requirements of large scale production may not be met in a rural economy where finance for enterprises comes from family members or accumulated meager profits or previous harvest. Another example of how businesses tap community knowledge can be observed from the publicly funded Human Genome Project, its successful completion is going to provide a deeper understanding of the organization of human genes and chromosomes. This knowledge provides insights into development of new medicines which pharmaceutical companies are set to exploit profitably. The common thread here is that, the public has contributed to gene knowledge, yet it now provides the opportunities for businesses to develop new medicines or drugs or ways of treatment that can be sold to the public for a profit. Investment in basic science by

governments is yet another example. Large corporations may have the capacity to engage in R & D to expand on the basic community's knowledge and skills to create new products. However, this may not be the case for small firms in many developing countries. Consequently, upgrading should be seen as a comprehensive societal process, involving labor skills, capital goods, infrastructure and the state administration. Administrative issues may include; prevailing laws or rules, conventions, tax laws, contracts, administrative rules e.t.c , which determine the choices of firms.

The discussion above, relates only to market institutions in terms of property and market exchanges. These institutions are just part of the interconnected institutions of the whole social system that form an economy. There are also socio-political institutions. These may include state agencies intended to protect and provide socially generated obligations or collective resources, exercising public power (Campbell, Hollingsworth and Lindberg, (1991)). There are also informal networks, whereby transactions are conducted on the basis of mutual trust and confidence (say in a 'community'), transactions that may not be legally enforceable. Other important institutions are associations of both worker and business interests to promote members advantages (Streek and Schmitter, 1985). All these diverse institutions are involved in the formation and circulation of wealth discussed above. However, power is necessary for the running of these institutions that constitute any orderly social system (Rutherford and Samuels 1996, Don Kanel, 1974). Power here is seen in terms of 'responsibility and the capacity to coordinate and concentrate resources and foresee dangers and opportunities'(Don Kanel, 1974, pp. 834). Mainstream neoclassical economists pay scanty attention to the importance of social institutions of governance on the economic performance. According to Hollingsworth et al. (1994), "The discipline of economics was originally concerned with

social institutions and there consequences for economic outcomes, but the ascendant neoclassical synthesis, in its quest for "rigor" and "information economy" focussed its range of inquiry on markets and, occasionally, organizational hierarchies" (page 4). According to Kenneth Boulding (1977), there is an implicit assumption is that institutions do what they are supposed to do, which sometimes prove to be unrealistic. From the business point of view, power may take a different form, economic power may be used to restrict access of other firms from the same source of earnings. Businesslike restrictions may take the form of predatory pricing, exclusive contracts, cartels and so on. The businesslike limitations may find support through political means such as copyright rules, patents, export restraint agreements between nations, tied aid - ensuring markets for firms from the donor nations, labor policy, tariffs, quotas, embargoes, occasional use of force, legal monopolies (Nitzan 1998). Power may thus be used to manipulate and encourage certain market outcomes that vested interests desire (Klein, 1980).

In many sub-Saharan Africa countries, the assumption that 'institution do what they are supposed to do' seems quit unrealistic. Indeed perhaps, after so many years of development advice to developing countries, IMF and World Bank are now realizing the importance of institutions. The *World Development Report, 1997, World Bank, 1997,* says in part

> *"A survey, specially commissioned for this report, of domestic entrepreneurs (formal and informal) in sixty nine countries, confirms what was already known anecdotally: that many countries lack the basic institutional foundations for market development. High levels of crime and personal violence and unpredictable judiciary combine to produce what this Report defines as 'lawlessness syndrome'......... Far from assisting the growth of markets, such actions squander the state's credibility and hurt market development". (Page 4).*

The report comes up with a credibility index showing that there is a strong correlation between reliability of institutions and economic performance in terms of growth and investment. Corruption, discrimination, ethnicity, misappropriation of public resources are just a few manifestations of institutional weaknesses in Sub-Saharan Africa.

The failure of public institutions to provide basic requirements of transport, health, communication, education and so on, may be a reflection of abuse of power or a general lack of administrative capability. Within the central government, ministries, local governments and other agencies, this incapacity may manifest in terms of avoidance of accountability, discrimination, ethnicity, sycophancy, overstaffing, under staffing, waste of resources, bribery and undue delays, just to mention a few. Stone and Stone's (1976) observation that, excessive preoccupation with economic factors and measures is myopic since good policies and programs are not self-implementing, though dated still remains relevant in Sub-Saharan Africa. "Preoccupation with design of complex econometric models may be anachronism when the primordial tasks are to develop enough working infrastructure and competence to govern effectively and to fulfill basic requirements of transportation, communication, health, education, agriculture, industry, commerce and investment. Societal advance requires a foundation of operating capacity for a host of public and private activities" Stone and Stone, 1976, page 194. The discrepancy between normative policy and its implementation results can be explained by administrative capabilities (Zysman et al, 1990).

In most cases, failure of institutions to meet its responsibility in light of available means is a symptom of misuse of power, especially where ascendency to office is determined not on merit but by such political factors as ethnic loyalties or patronage. Every office of power within the social system has its responsibilities, be it a political office, trade union, industry or

civil service. The social system (including market institutions) as a whole is made up of different hierarchies and characteristics of power. For the system to operate successfully, individuals in power have to fulfill the functions that their offices require of them. However, cases of abusive use of power, whereby individuals use public offices for parochial interest instead of serving social justice abound in Africa. In extreme cases, whenever the judicial and political processes fail violence erupts, ethnic skirmishes are not uncommon. In most Sub - Saharan Africa there is lack of adequate separation between public and private functions of government officials. Consequently, some officials use public office for personal enrichment. This aspect has been described variously by different authors. Bayart (1993) calls it the 'politics of the belly', Chris Allen (1999) refers to it as 'spoils system' and Southall (1999) on Kenya refers to it as 'kleptocracry'. In all, it has resulted in gross abuse of power or failure to perform the functions required of the public office holder. According to the World Development Report, 1997 such power abuses may be tackled through formal checks and balances, involving separation of powers, democratization and liberalization. However, these remedies do not address 'state weakness' in the sense of providing a strategic direction for economic growth. Upgrading is a strategy and calls for mobilization of the power of firms, workers and other resources. It is a process which by no means involves conflicts. The results of market allocations are evaluated by the interested or affected groups and contested politically (Klein, 1980). The reason is that powerful individuals sometimes exact their power, to achieve the outcomes they wish to encourage. There is no guarantee that conflicting interests will produce outcomes that are in the public interest. Consequently, the formation and flow of wealth discussed above is a political as well as an economic process. The market economic outcomes shaping political responses and political activity shaping economic

outcomes. Thus economic stagnation in Sub-Saharan Africa is an economic as well as a political problem.

1.2.0: Research Issues

In the light of theoretical framework discussed above, this paper looks at both qualitative and quantitative factors in an effort to understanding private investment activity and the related economic performance of Kenyan economy. The first section of this paper discusses the overall framework and more important it questions the neoclassical approach to the study of private investment. We argue that the approach fails to recognize the weaknesses of the private sector in developing nations. Attempts are made to discuss an alternative approach to the study of private investment in developing nations.

In economic analysis as in many other fields, it is usually important to concentrate on certain issues since it is impossible to develop an all-encompassing model. Part two of this study concentrates economic data analysis involving hypothesis testing in an effort to explain the observed performance in private investment. The basic hypothesis relates to the relationship between actual profitability and private investment. This hypothesis is in conformity with the classical theory of capital accumulation as well as the ideas of Keynes and Kalecki on investment. Although this hypothesis has been widely tested in the context of industrial countries, studies on developing nations are scarce. Other theories of investment do not accord profits or actual returns a direct causal effect on investment. In the literature on investment, most studies have been carried out within the neoclassical tradition. Although these theories may be relevant to developing countries, institutional factors as well as, in some cases data unavailability limit their applicability. In chapter 2, we discuss the important

characteristics of investment environment in developing countries. For example, generally speaking the Q theory which is an extension of the neoclassical theory links investment to the asset markets. Since the financial and capital market sector underdeveloped in many parts of Africa, its objective applicability is limited. The other issues that form the core of this study relate to the interaction between the state and the financial sector with respect to contribution to capital accumulation in the economy. The financial sector is unique in that by providing financial services to governments, traders and producers facilitate further accumulation. To promote investment, most governments opted to control interest rates, owned banks and directed credit to favored sectors. Following the work by Mackinon and Shaw (1973), such practices by the governments are now deemed as anti-development. Financial repression, it has been argued inhibits financial intermediation, investment and growth. Chapter four of this study discusses the nature of credit markets considering new theoretical developments, especially the interest rate liberalization theory.

From section 1.1.0 , it has been argued that the state has to perform certain functions which can not be possible for the private sector but are necessary for the latter's expansion. Some public goods, are directly supportive of private business and are thus likely to promote investment. Public investments in roads, railways, ports or basic infrastructure have a complementary effect on investment. To finance its expenditures, the government however may 'crowd out' private investment. These issues are discussed in chapter 3 and also in chapter 5 at a macroeconomic level. Much part of this study emphasize the importance of profits and credit for private investment. It is recognized that availability of finance is not enough, the investor has to be convinced that what is produced is sold and allow for some profit. For this reason, we link investment to its profitability, availability of credit and

aggregate output by constructing a small macro model in chapter 5. Through policy simulations we investigate the effects of 'crowding out' or 'complementarity' and interest rates changes on investment and related macroeconomic variables.

Another important issue relates to stability especially macroeconomic stability. Indeed, World Bank study on the East Asian NIC's has partly attributed the success of the Asian NIC's to a stable macroeconomic policy environment. Poor contact of fiscal (taxation and expenditure) and monetary (money supply) policy may adversely affect private investment. To investigate the importance of macroeconomic policy, we have adopted a cross country approach, to see whether such stability may explain differences in capital formation across economies. We use data from sub-Saharan countries for the cross-country analysis.

1.2.0.1: Other problems of capital formation in Kenya

There are other important problems of capital formation in Kenya that are not addressed in this study. Foreign direct investment as well as the efficiency of use of capital resources has been declining in Kenya. These issues are not examined further in the study but are discussed here to give a broader picture on investment in Kenya. An issue that is not discussed here relates to human capital, the discussion in section 1.1.0 suggests that, the quality of the societies' 'soft' technology may determine the type of investment that takes place. Resource constraints limit the study of this issue, especially the importance of human capital. During the last two and half decades, the importance of Foreign Direct Investment in Kenya's Gross Domestic Investment has declined overtime. The highest contributions were recorded in 1970's (about 4.4 percent of Gross Domestic Investment or 1 percent of GDP during 1975-1980). Currently Foreign Direct Investment accounts for less than 1 percent of

GDP. This probably suggests that the policies[10] adopted to attract Foreign Direct Investment have not have been quite successful in the face of declining domestic economic activity.

Although there is no standard measure of what level of Foreign Direct Investment is appropriate in any economy a comparison with some other countries, shows that in quantitative terms it is less significant in Kenya. See the table below:

Table 1.1: Foreign Direct Investment in Selected Countries (Averages 1981-1995)

Country	Foreign Direct Investment % of GDP	F. Direct Investment % of Gross Domestic Investment	GFCF % of GDP
Botswana	2.3	9.5	27.3
China	1.8	4.7	30.2
Kenya	0.29	1.3	19.01
Indonesia	1	2.5	25.7
Malaysia	4.8	14.1	32.7
Seychelles	6.7	28	23.5
Thailand	1.3	3.67	33

Computed From: World bank, World Development Indicators, 1997.

The efficiency with which capital resources are used as measured by the incremental capital output ratio (ICOR)[11] has been disappointing. The ICOR shows how much capital is required to produce a unit of GDP. The movement in the overall ICOR is shown in table 2 -statistical Appendix. It can be seen that the deterioration in investment activity was accompanied by increasing inefficiency. However, there are signs of improvement in the ICOR in 1996.

Sectoral ICOR's between 1994 and 1996, show that agriculture had the lowest ICOR of about 1.5, followed by services with an ICOR of 4.6 and industry with an ICOR of about 11.4. Over the period 1991 and 1993, the growth in agricultural output was negative, this was

[10]The measures that have been adopted by the government include; establishment of Export Processing Zones (EPZ's) (In EPZ's firms enjoy a 10 year tax holiday and duty free import of machinery), reduction of duty to 10 percent for foreign financed ventures, manufacturing under bond e.t.c

[11]The ICOR is the ratio of investment to change in GDP, both in constant local currency.

mainly due to bad weather and ethnic clashes that disrupted agricultural activity. Change in industrial output in 1992 was also negative. With these considerations, the sectoral ICOR was computed for the last three years of the sample period[12].

A comparison of ICOR's with other selected countries shows that Kenya has not fared well. The table below shows the average ICOR for the period 1987-1995 for Kenya and other selected countries.

Table 1.2: Incremental Capital-Output Ratios for Selected Countries

Country	Average (1987-1995)
Kenya	13.7(6.6)[13]
China	4.4
Indonesia	4.1
Malaysia	3.8
Korea	4
Singapore	4.4
Ghana	3.1

Computed From: World bank, World Development Indicators, 1997.

1.2.1: Overview of the Kenyan Economy

Kenya is a small open 'mixed economy' with a per capita income of US $250 in 1996 having fallen from US$ 410 in 1988. Agriculture is the mainstay of the economy accounting for about one quarter of GDP and caters for almost three-quarters of the labor force. Industry accounts for about 16 per cent of GDP and employs about 8 per cent of the labor-force. Coffee and tea account for about forty per cent of merchandise exports. Lately, horticultural products are becoming important. Tourism has become the single largest foreign exchange

[12]A comparison of the sectoral ICOR's at other periods does not alter the picture, for example over the period 1995-1990, the average ICOR for agriculture was 1.24, compared to industry ICOR of 5.7 and services sector 4.5. It can then be seen that ICOR for industry increased relative to the earlier period.

[13]If 1992 and 1993 (when the economy registered worst economic performance) are excluded the ICOR is 6.6 still reflecting a relatively higher level of inefficiency.

earner having overtaken coffee in 1987. Kenya is not an oil producing country. The major imports include: machinery, transport equipment and crude oil.

Kenya's economic system is described as a 'small' open economy because although the economy is linked to the rest of the world through trade and finance, Kenya's policy actions can not influence the world economy- in this sense it is small. For example, prices of exports and imports are determined by demand and supply forces in the international markets, over which Kenya has no control. Another factor that affects export earnings as well as grants, loans and direct foreign investment are developments of the industrialized countries which, again we take as given. In 1994 Kenya's exports of goods and services stood at about 46 percent of GDP at factor cost while imports of goods and services as a percentage of GDP at factor cost was about 42.1 percent. As a result, economic influences from abroad have a powerful effect on the well-being of the Kenyan economy.

1.2.1.1 Overall Economic Performance

During the first decade after independence in 1963, the economy registered remarkable growth. Real GDP growth averaged about 7 percent. This remarkable economic performance was largely due to high growth in the agricultural sector, favorable terms of trade and industry expanded rapidly with import substitution giving good results. The economic growth of the first decade was reversed with the coming of the first oil crisis in 1973. Growth decelerated below 4 percent for much of the early 1970's. In 1977 there was a 'coffee boom'[14] , this coupled with favorable domestic conditions, especially good weather conditions for agriculture, growth in real GDP rose from 4.2 percent in 1976 to 8.2 percent in 1977.

[14]The average price of coffee, which is a major export, nearly quadrupled from about Shillings 10.40 /Kg in 1975 to Shillings 43.30 in 1977 . The prices of tea also rose at the same time (Tea is also a major export)

However, the boom was short-lived and by 1978, the second oil crisis was in the making. Oil prices more than doubled, rising from US $ 13 per barrel in 1978 to US$ 27 per barrel in 1979. The second oil crisis brought about sluggish growth in GDP as terms of trade worsened and import bill drastically increased.

On the international scene, in the early 1980's, there was a slow down in the global economy that led to reduced inflow of capital to developing countries. Faced with fiscal constraints, Kenya like many other developing countries turned to traditional donors for assistance. However, World Bank and IMF insisted on policy reforms, otherwise funds would not be forthcoming. Kenya was the first country in sub-Saharan Africa to receive a structural adjustment loan from the World Bank in 1980. Early efforts on adjustment foundered because of reluctance by the government to liberalize the economy.

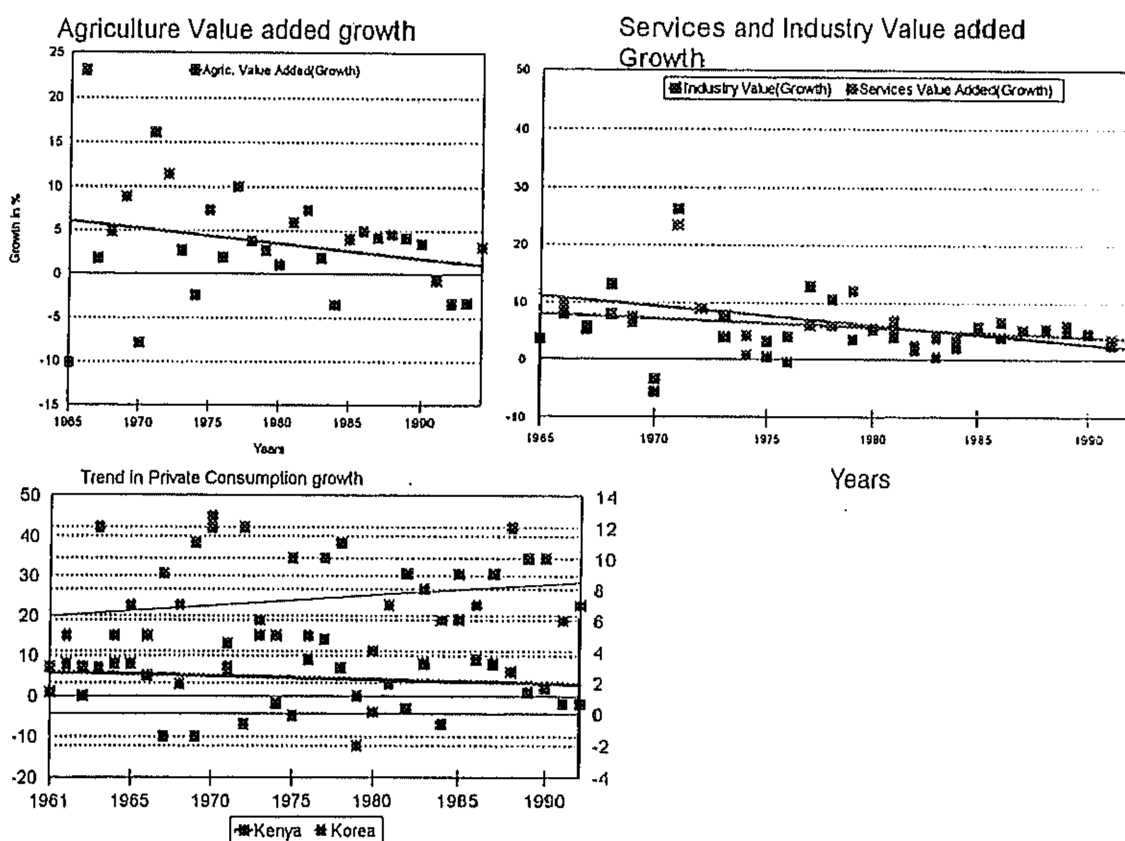
In 1984, the country was rocked with a severe drought, real output in agriculture fell by 3.9 per cent and on the overall GDP grew by less than 1 per cent. During 1985-86, the economy showed signs of recovery, mainly due to strong performance in Kenya's leading sector, agriculture, which grew at about 4.9 percent following good weather conditions and improved prices of tea and coffee on the international market.

Over the period 1989-1993, the economy registered dismal economic performance, mainly due to prolonged drought, macroeconomic imbalances and political instability during the transition to multiparty politics[15]. In 1994 the economy started showing signs of recovery, this recovery has been attributed to improved macro economic management and favorable weather conditions (Economic Survey, 1994). Trends in major economic indicators reveal that there has been a slow down in economic activity relative to the levels recorded in 1960's and

[15]Ethnic clashes in the Rift Valley disrupted economic activity. The arising insecurity also adversely affected tourism industry. In a bide to coarse the government in accepting multiparty politics, donors suspended balance of payments support in November, 1991.

1970's. The chart below shows a declining trend in growth in value added in major sectors of the economy. Growth in real private consumption fell indicating perhaps deteriorating average standards of living. This is in contrast to the successful NIC's where growth in real private consumption was increasing. Apart from showing growth in value added by major sectors, Chart 1 also compares the trend in growth in real private consumption in Kenya and Korea, a similar picture emerges when Kenya is compared with other NIC's. Perhaps this dismal economic performance helps explain the observed investment activity. See the chart below:

Chart 1: Selected Macroeconomic Performance Indicators (1965-1994)



1.2.2: Structural Adjustment Programs in Kenya

As mentioned above, although Kenya was the first country in SSA to receive structural adjustment support loan from the World Bank to embark on reforms, progress on reform was very slow. It was not until 1986, when the government prepared a policy document, *Sessional Paper No. 1 of 1986 on 'Economic Management for Renewed Growth'*, that the case for structural adjustment was reexamined. The approach adopted by the government has been gradual and phased on sectoral basis. Below we give a brief overview of structural adjustment reforms in Kenya.

1.2.2.1: Agricultural Sector

Kenya's population is largely rural (about 78 percent) and the economy is heavily dependent on agriculture. Although the share of agriculture in GDP is declining as the economy industrializes, agriculture still remains the single most important sector. In 1972, its share in GDP stood at 34.2 per cent, 28.4 per cent in 1989 and accounted for about 25 per cent of GDP in 1996. Through strong backward and forward linkages, agriculture still remains the engine of growth for manufacturing and services sector. Small holder agricultural has been the dominant mode of production. This is partly due to high population growth leading to land fragmentation as well as the distribution of land to native Kenyans after independence.

In the 1980's, agricultural growth decelerated apparently because the factors that had contributed to rapid growth in earlier years (especially expansion in area under cultivation) could no longer be sustained. Further growth would only come by increasing yields or productivity. Adjustment measures in this area aimed at addressing issues such as; stagnation in use of inputs such as fertilizers, producer incentives, inefficient state agencies in provision of essential agricultural services and falling investment.

In 1990 the government liberalized prices and importation of fertilizers. The government also started decontrolling prices of agricultural products gradually. Efforts have also been made to eliminate legal monopoly of state corporation in the marketing of agricultural products. As part of fiscal reform in agriculture, the state set out to eliminate food subsidies and increase spending in agriculture. However, from Chart 1.3 clearly investment in agriculture as in industry and services has fallen below levels registered in 1970's.

1.2.2.2: Industry and Trade

The share of manufacturing in GDP currently stands at about 13 per cent. After independence, the government adopted Import Substitution Industrialization (ISI) strategy, that sought to replace previously imported commodities with domestic production. Consequently domestic firms were protected from external competition. By 1980's, it became apparent that growth of manufacturing sector could not be sustained purely by expansion in domestic demand and displacement of imports. Adjustment measures in industry and trade have sought to move toward an export oriented system. The government also sought to reduce regulatory and licensing requirements in industry and trade. Incentives for export include; establishment of export processing zones, a competitive exchange rate and liberalization of the import regime.

Reforms have also involved liberalization of the capital account of the balance of payments, that is trade in financial assets. Exchange rate policy in Kenya has evolved from a peg to 'a basket of currencies' to a managed float.

1.2.2.3: Public Sector

As briefly discussed above, after independence the government followed a policy of 'Kenyanization' . The desire to 'Kenyanize' the economy and achieve rapid development led

to an increase in public ownership not only in the traditional activities such as utilities but also industry and commerce. In early 1993 there were 250 commercially oriented enterprises producing goods and services for profit in which the government held equity. On the other hand, civil service employment increased rapidly as well as the salary bill. To finance its activities, the state became a net user of private savings. Table 1 (Statistical Appendix) shows movements in the budget deficit as well as public saving.

To finance the budget deficit, external borrowing also increased rapidly. For example the Debt:GNP ratio increased from 48 percent in 1980 to about 89 percent in 1992. Public sector reforms have sort to reduce the budget deficit through privatization and or divestiture from commercially oriented enterprises and general cuts in government expenditure as well as improve revenue collection measures. Civil service reform has mainly focused on reducing the personnel cost of delivery of government services by reducing the number personnel in the civil service.

1.2.2.4: Financial System and Capital Markets

Kenya has a range of financial institutions including commercial banks, near-bank financial institutions (NBFI's), building societies, saving and credit societies, insurance companies, pension funds, hire purchase companies and a stock market. In 1995 there were 51 commercial banks, of these, the largest four (Barclays Bank of Kenya, Commercial Bank of Kenya, National Bank of Kenya and Standard Chartered Bank of Kenya) controlled about 81 percent of banking system deposits. There are concerns that the banking system operates in an oligopolistic manner. According to the National Development Plan (NDP, 1997-2001), the central bank of Kenya will introduce "regulations to check oligopolistic tendencies in the sector..." (NDP, 1997-2001, page 39). Development Finance Institutions (DFI's) are an

important set of financial institutions set up by the government to provide long term finance. The main DFI's are Kenya Industrial Estates (KIE) and Small Scale Enterprise Finance Company (SEFCO). These state owned institutions' main objective has been to promote indigenous entrepreneurship, lending mainly to small scale enterprises. The level of monetization of the economy, as measured by the ratio of broad money supply as a ratio of total output, averaged about 35 percent over the period 1990-1996, from an average of about 30 percent over the period 1980-1990.

The stock market in Kenya has existed since early 1960's however it is only until recently that it has started operating as a capital market place. By 1986, there was no market for private securities (bonds). However, although the overall capitalization of the market has been growing, the market still remains highly underdeveloped and illiquid as evidenced from standard quantitative indicators of stock market development. These indicators include; number of listed companies, increase in market capitalization, share prices and changes in value traded (as a measure of liquidity).

The table below shows the performance of the Kenyan capital market (Source: Emerging stock Markets Fact book, 1997, IFC).

Table 1.3: Stock Market Development Indicators (1987- 1996)

	1987	1991	1996
No. of listed companies	53	53	56
Market Capitalization (US $ mn)	424	453	1,846
Δ Market capitalization		6.8%	307%
Value Trading (US $ mn)	-	11	67.1
Δ Stock Mkt. Index	45.3	4.7	-10.2

Source: Emerging Stock Markets Factbook 1997, (IFC). International Financial Corporation

The standard indicators of stock market development were up in 1996. Except for the fall in the stock market price index, the number of companies listed, market capitalization and trading value showed a remarkable increase in 1996. The reform measures being undertaken by the government should give the market an impetus for growth. These measures include; privatization, liberalization of foreign investor participation (the market was opened for foreign participation in 1995 for the first time in three decades) and strengthening of regulation and management of the stock exchange through the Capital Markets Authority (CMA)[16].

Apart from strengthening the capital markets, Structural Adjustment reforms have aimed at addressing constraints that existed in the financial sector. For example, regulations widely varied between NBFI's and commercial banks. NBFI's were subjected to lower credit ceilings, lower capital requirements and their supervision by the Central Bank was less stringent. These disparities in the regulatory framework led to mushrooming of NBFI's that were undercapitalized and poorly managed. In 1986 a credit squeeze led to failure of a number of NBFI's. In the contact of monetary policy, the main instrument of monetary policy was credit ceilings and interest rate regulation by the Central Bank of Kenya.

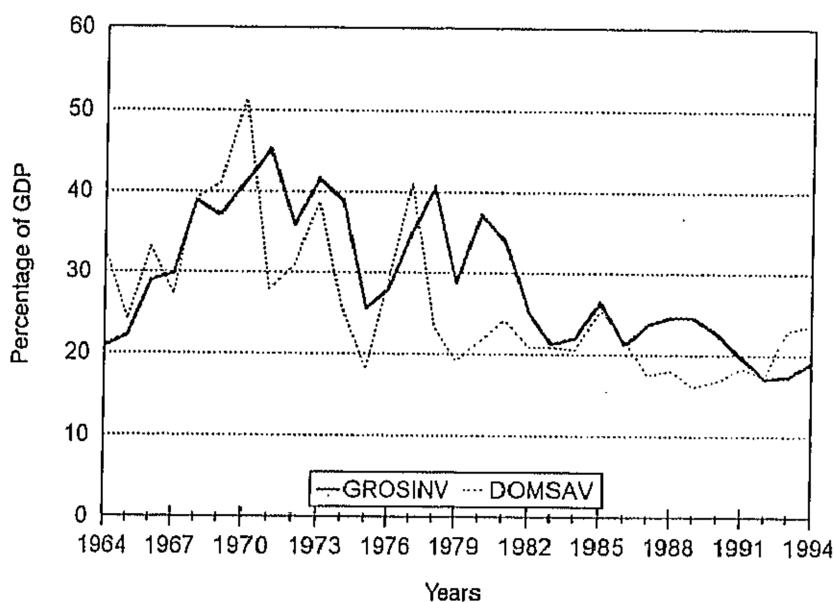
Among the reforms implemented in this sector include; deregulation of interest rates in 1991 and movement a way from direct controls on credit to indirect measures like open market operations and minimum reserve requirements (as a means of contacting monetary policy). The Central Bank has stepped up its supervisions of the banking sector. This section has not given a comprehensive review of the reform measures undertaken by the government but it provides a general survey of the reforms in the major sectors showing that efforts have been made toward liberalization.

[16]The CMA was established in 1990 to 'facilitate and promote development of an active, effective and efficient securities market' in Kenya. (National Development Plan, 1994-1996, Republic of Kenya, page 17).

1.2.2.5: Trends in Private Investment in Kenya

Chart 1 below shows movements in the level of domestic investment and savings in Kenya over the period 1965-1994. Data on private investment separately is available only from 1975 and is shown in table 1.2 below.

Chart 1.1: Gross Investment and Savings as a percentage of GDP 1964-1994



Data Source: World Bank, World Data, 1995. GROSINV is gross investment comprising gross fixed investment and change in stocks as a ratio of GDP. DOMSAV is real domestic savings as a ratio of GDP

The above chart reveals two important trends in investment activity in Kenya, increasing and high investment over the period 1964 until late 1970's (or probably mid 1970's) and a declining trend beginning late 1970's. The economy experienced three major external shocks in the 1970's. In 1973, there was the first oil shock whose impact on the economy is reflected in a decline in investment in 1973-4. However, there was recovery that was helped by the commodity price boom of 1977. This 'coffee boom' as it came to be called was short

lived, in 1978 the second oil shock was in the making, its impact is also reflected in the chart above. This marked the end of high investment in Kenya, the following two decades reveal a dismal performance in investment activity.

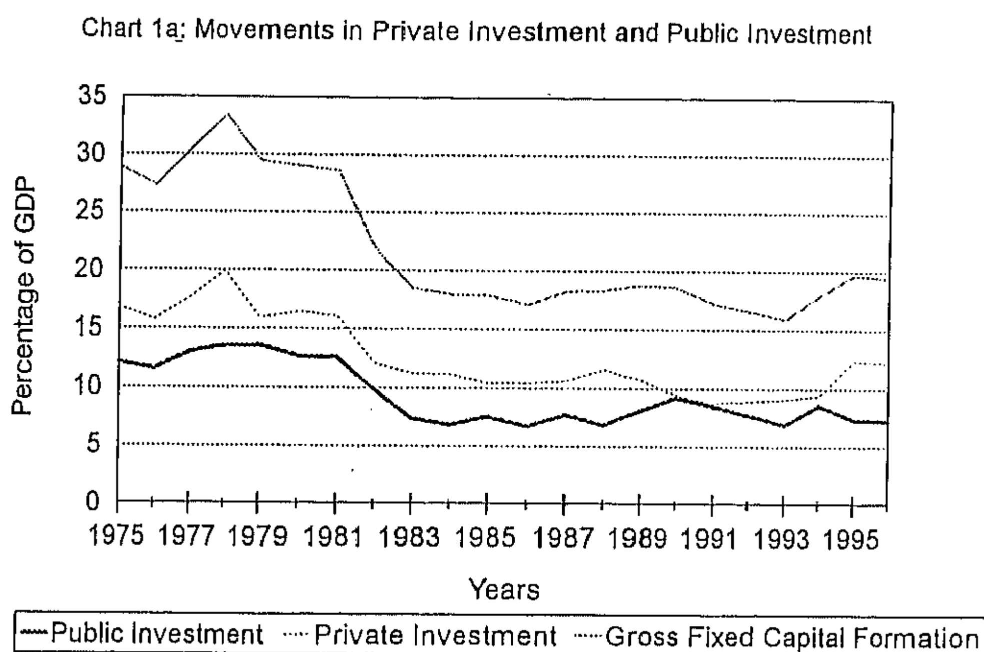
Chart 1.2 shows movements in private and public investment over the period 1975-1996. (As indicated above, data on private investment separately is available from 1975.) It can be seen that private and public investment fell drastically after 1978 and then stabilized at lower levels than those registered in late 1960's and earlier part of 1970's. Private investment fell by 3.1 per cent per annum while public investment fell by 2.9 per cent per annum over the period 1975-1996[17].

On the overall, real Gross Fixed Capital Formation (GFCF)[18] as ratio of GDP declined by 2.1 percent per annum. Real GFCF averaged about 19 percent of GDP over this period. Private investment averaged 10.7 % while public investment averaged about 8 percent (or 42 percent of real GFCF). Private investment as a share of real GDP fell from about 16 percent in 1979 to about 9 percent in 1994, on the other hand, public investment as a ratio of GDP fell from about 13 percent to 9 percent over the same period.

[17]These growth rates are obtained by running a regression equation on the log of real investment on a constant and a time trend.

[18]Gross Fixed Capital Formation (GFCF) refers to gross investment less changes in inventories, in constant local currency.

Chart 1.2: Movements in Private Investment and Public Investment



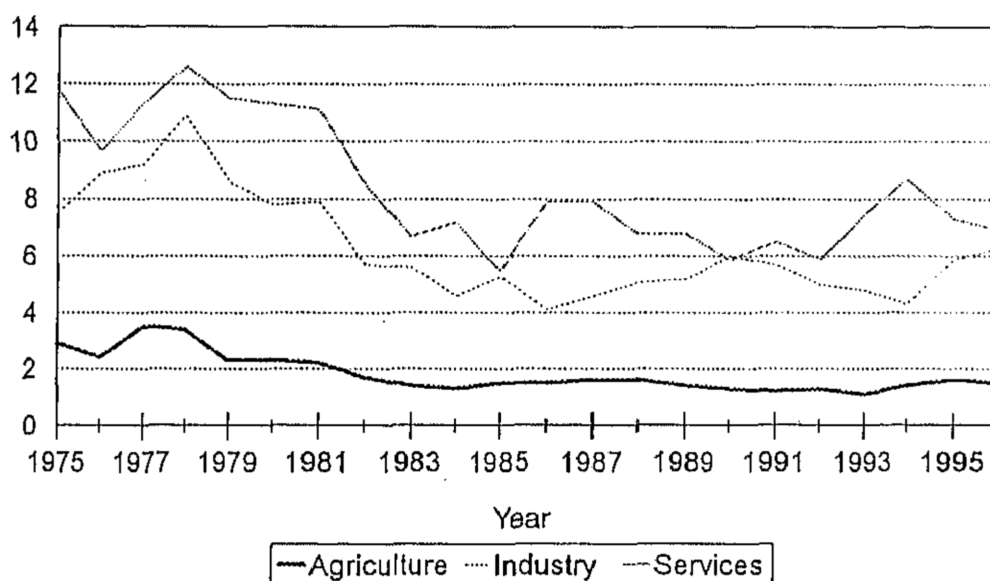
Data Source: Statistical Abstract, Economic Survey, Various Issues. Gross Fixed

The dismal performance in investment activity is also reflected in investment performance by sector. Chart 1.3 below shows investment activity by major sectors; agriculture, manufacturing and services[19]. Investment in agriculture that averaged about 2 percent of GDP until late 1970's fell to about 1.4 percent of GDP in 1980's and early 1990's. In 1995 and 1996 there was some slight recovery in investment in agriculture. Generally, investment in agriculture has followed closely the overall performance of the sector which in turn depends much on weather conditions and performance of major export crops tea, coffee and lately horticultural products. The slight recovery in investment since 1992, has been

[19]Agriculture is defined to include; agriculture, forestry and fishing (together account for about 25 percent of GDP in 1994); industry (accounting for about 16 percent of GDP in 1994) comprise; mining and quarrying, manufacturing, building and construction and electricity and water; on the other hand, services constitute all the other sectors excluding government and non-monetary economy, and accounts for about 35 percent of GDP in 1994. Data is from Government Sources; Central Bureau of Statistics, *Economic Survey and Statistical Abstract*, Various issues

attributed to opening up the market for imports of passenger motor vehicles, parts and accessories and the construction of oil pipeline to Western Kenya (Republic of Kenya, *Economic Survey*, 1994).

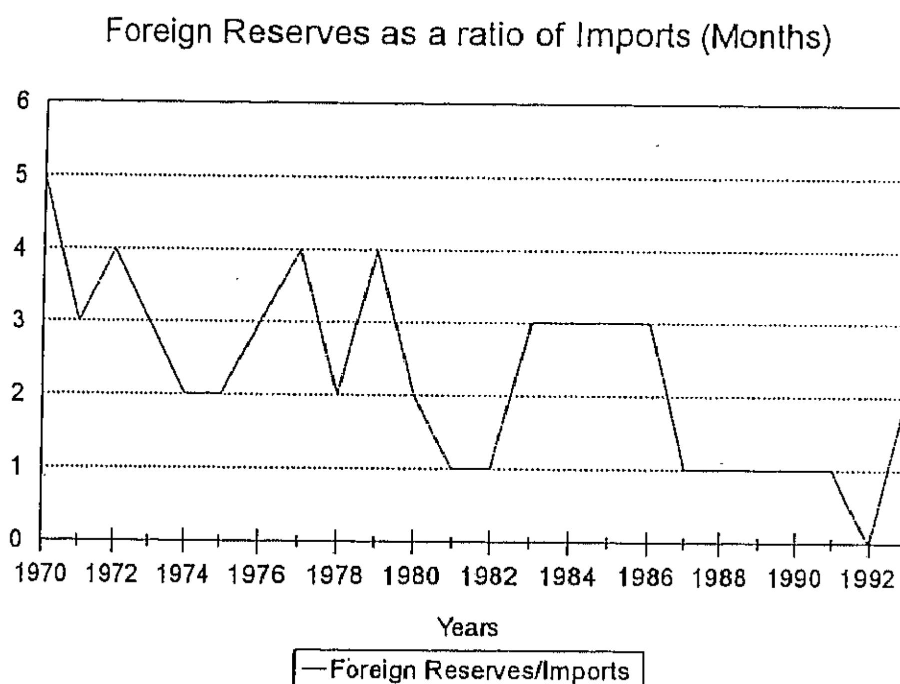
Chart 1.3: Investment as % of GDP by Major Sectors



Data Source: Republic of Kenya, Central Bureau of Statistics, Economic Survey, Statistical Abstract, Various Issues.
Agriculture is the sum of agriculture, forestry and fishing. Industry refers to mining and quarrying, manufacturing, building and Construction and Electricty and Water

Kenya's investment is highly import dependent, implying that investment may be highly affected by external factors. The external position started worsening in 1970's but was slightly eased by the commodity price booms in later 1970's. Consequently, the foreign exchange reserve position was weakening making it difficulty for entrepreneurs to import capital goods. This meant new investment ventures would be hurt. The foreign exchange reserve position in terms of the value of imports is shown in Chart 1.4.

Chart 1.4: Foreign Reserves as a ratio of Imports (months).



Data Source: World Bank, World Data 1995

Over the period of study, there were also serious macroeconomic imbalances both internal and external. (See Table 1 in the statistical appendix). The terms of trade went against Kenya after the commodity price booms of 1970's. From 1981/82, the government became a net user of private savings as it's current account surplus turned negative. The worsening of government fiscal position together with the stabilization measures adopted in early 1980's may explain the observed fall public investment. The high investment in 1970's could be explained by Import Substitution Industrialization (ISI) strategy that government earnestly pursued. The protection of import substitution industries ensured high profitability, through tariffs and quotas.

1.3.0: Socio-Political Aspects of Private Investment in Kenya

1.3.0.1: Introduction

This section draws from the discussion in section 1.1.0 and its purpose is to briefly analyze the development of the private sector in with emphasis on institutional factors. We discuss the role of the Kenyan government in promoting a private sector dominated by indigenous people and its current weaknesses. Though the government could have had a justification for empowering indigenous Kenyans to address the imbalances created during colonialization, we argue that the strategy adopted was flawed. The discussion is given within an historical context, not historically exhaustive but as a bridge to understanding the current situation. We also briefly discuss how political corruption, ethnicity politics and business interests undermine productive private investment.

1.3.0.2: The State and the development of the Private Sector in Kenya

This discussion of the development of the private sector is carried out along the lines of the theoretical framework in section 1.1.0. Specifically, the distinction of businesses between producers, merchants and financial enterprises. This framework is appealing on the basis of the strategy the government adopted at independence of controlling distribution of output in Kenya through marketing boards and Kenya National Trading Corporation (KNTC) and use it as an instrument to achieve Africanization of the economy. The state also attempted to create a financial capitalist sector dominated by African entrepreneurs but with dismal results.

At independence in 1963, Indian and European businesses dominated the private sector in Kenya (Hibara 1994). African businesses existed but mainly in trading activities and in a subordinate position. The post colonial government wanted to increase control over the

economy exercised by the majority Africans but was also concerned about retaining the capital owned by non-indigenous Kenyans. Faced with the threat of capital disinvestments soon after independence, the government moved to stem outflow of foreign capital and gain the confidence of foreign investors by enacting the Foreign Investment Protection Act (FIPA) of 1964. This Act guaranteed overseas investors the right to repatriate their returns and interest on loans. The post colonial government rejected nationalization as a general policy but sought to support African businesses (Africanization) to address the imbalances that existed in the ownership of businesses in commerce and industry. State agencies were set up to facilitate Africanization. Some of these include; the Joint Loan Board (JLB), Kenya Industrial Estates (KIE) and Kenya Institute of Business Training (KIBT). These bodies were to provide technical and or financial assistance to indigenous entrepreneurs. Within the agricultural sector, the government set up marketing boards that controlled crop purchase and distribution. For instance, Kenya Cooperative Creameries (KCC) for Milk, National Cereals and Produce Board (NCPB) for maize, wheat and rice, Cotton Lint and Seed Marketing Board (CLMB) for cotton and Kenya Meat Commission (KMC) for meat products. The government also set up the Kenya National Trading Corporation (KNTC - a state corporation) and by having monopoly in the distribution of goods within Kenya, set to nurture African entrepreneurs by appointing them agents and providing them with capital. It was hoped that they would eventually take over the distribution of goods within Kenya and the import-export business that were dominated by European and Indian trading houses.

Trade licensing was also used as a means to achieve indigenization. In 1967, the government passed a Trade Licensing Act (The 1967 Trade Licensing Act) that effectively barred 'non-citizens' from trading beyond the central areas of towns. This was meant to

increase the share of business for African traders. Some years before independence many foreign companies concerned about the rise in African Nationalism had started carrying out Africanization programs by appointing Africans as their retailers and wholesalers. British American Tobacco (BAT) was among the first companies to start carrying out such a program. Other subsidiaries of Multinational Corporations (MNCs) such as such as Kenya Breweries, Elliots Bakery , Bata followed suit. These African merchant capitalists would later form the ruling class and important allies of multinationals (Leys, 1974). The government too set to participate directly in productive activities. In 1986, the government held equity in 103 commercially oriented corporations either wholly or partially, directly or indirectly through state Development Finance Institutions (DFI's) such as Industrial and Commercial Development Corporation (ICDC), Industrial Development Bank (IDB) and Development Finance Company of Kenya (DFCK).

In early 1970's it was apparent that African entrepreneurs were taking advantage of the opportunities availed through Kenyanization measures as briefly discussed above. In 1972 the proportion of new private firms being formed in Kenya by African entrepreneurs exceeded for the first time those formed by the Kenyan Indians. As Swainson (1977) would observe, "This reflected an increasing amount of merchant capital accumulation taking corporate forms......... By 1973 African firms constituted nearly 50 percent of all private firms forming in that year" (Swainson, 1977 page 44).

Another area where indigenous capital ventured was in credit institutions. Since early 1970's Near Bank Financial Institutions (NBFIs) started coming up mainly set up by indigenous Kenyans as well as subsidiaries of existing banks. NBFI's were subjected to lower credit ceilings, lower capital requirements and supervision. Assets of NBFI's as a ratio of Gross Domestic output increased from about 6 percent in 1975 to about 19 percent in 1985. In 1986, these institutions belonging predominantly to would be African financial capitalists run into problems because of poor management and non-performing loans. These included: Estate Finance Company, Home Savings Estate Building Society, Rural & Urban Finance Company, Continental Bank ,etc. These ailing institutions were later taken over by the government and consolidated in to the Consolidated Bank of Kenya in 1989.

Despite government efforts at Kenyanization, by 1989 it had become clear that indigenous capitalism had failed to make headway in commerce and industry and still remained subordinate to non-indigenous capitalists and or entrepreneurs. The failure of African entrepreneurs may be attributed partly to lack of skill and experience in management of large scale industrial and commercial activities. Studies by scholars such as Hibara, 1994; Kitching, 1980; Lofchie, 1994; Chege, 1994 and Barkan, 1994, suggest that there was realignment of economic and political power with the change in political power from President Kenyatta to Moi in 1978, which affected the growth of African businesses. President Moi is from the Kalenjin ethnic group while Kenyatta was a Kikuyu. It has been argued that president Moi wanted to build his own power base from his ethnic group, this may have been aggravated by the events leading to Moi's ascendance to power. The Gikuyu Embu Meru Akamba Association (GEMA, a conglomeration of four ethnic groups; Kikuyu, Embu, Meru and Kamba) had led a conspiracy to change the constitution in late 1970's to prevent Moi, a non Kikuyu from ascending to power. GEMA had been established by leading Kikuyu personalities most of them with large business interests and close to power during Kenyatta's reign. Notwithstanding, there was an attempted coup on Moi's government in 1982. GEMA was banned in 1982 as a tribal organization. Some scholars had seen the formation of GEMA as constituting the main arm of Kenyan industrial Capital, and

spearheading the move of indigenous capital into industrial production (Swainson 1977). The leading industrialists in Kenya were mainly from Kikuyu ethnic community. Most of them were close to the center of power or held key positions in state institutions (See East African standard - online edition, Friday, 8,2000: "Can one justifiably call Moi's Government tribalistic?"). Positions they apparently used to further their business interests. Kikuyu industrial projects started disintegrating in late 1970's, these included firms like Tiger shoe company, Chui soap Company, J.K. Industries, and madhupaper international (Hibara 1994). If it is true that the fall of Kikuyu businesses was related to change in power, then either these firms were not robust enough to survive without state support or perhaps the connection of these would-be African Industrial capitalists with GEMA jeopardized their positions in forging new alliances.

Other reasons for failure of African business may be due to the fact that, the state did not divest from commercial entities as had been envisaged, thus Kenyanization remained representational in state ownership. Most of the state identities that had been set up to promote African businesses ran into serious financial problems because of poor management. In the 1989-1993 Development Plan, referring to the institutions set up to facilitate indigenization, it is noted that "Recent evidence show that some of the entities are inefficient, poorly managed, unprofitable and a burden to the tax payer on account of heavy budgetary subsidies made to them year after year" page 152. The Development Plan further noted that "Although after more than two decades of independence considerable progress has been made in the Kenyanization of agriculture and the management of the public sector activities, most Kenyans are still unable to participate in the ownership and control of large scale industrial and commercial enterprises.....," page 153. So finally the government seemed to accept that Kenyanization in commerce and industry had failed. In 1989 non-indigenous Kenyans constituting 2 percent of the total population controlled more than 65 per cent of total turnover in manufacturing and trading activities (Republic of Kenya, 1989). Kenyan Africans

have constituted mainly merchant entrepreneurs. The majority are small scale wholesalers and retailers. The type of businesses at this level compares to perfect competition since almost everybody sells the same product, as a result the level of accumulation is very small. In agricultural production, a reasonable level of Kenyanization has taken place since most of the agricultural output is produced on small holdings by indigenous Kenyans. On the hand, industrial and financial sectors are largely under control of non-indigenous Kenyans. Indigenous entrepreneurs dominate small scale and Jua kali enterprises outside agriculture. (Jua kali is a Swahili word for 'hot sun' it refers to small scale business activities usually carried out in open air shades). However, more than 70 percent of these activities are found in trade and commerce, while manufacturing and services each comprise about 15 percent (Republic of Kenya, 1989).

There are other interesting aspects of the business-business relations and business-politics relations that may hamper upgrading.. The primal drive for businesses is pecuniary benefit and the means of achieving this end are numerous. Although to profit, the firm must produce, the relationship between profitability and output of goods and services is not a monotonic one. Businesses compete among each other to secure as much profits as possible. Sometimes they may collude or engage in practices that ensure their continued profitability while keeping others out. Business practices such as; predatory pricing, cartels (both formal and informal) and exclusive contracts are well known. Some political practices include; patenting, copyrights, tied foreign aid, quotas and tariffs, voluntary export restraints (VERs) and industrial policy are meant to secure profits for given firms and keep out others. Some of the political measures may generally be pursued to promote output and employment in an economy or may come about simply through business lobbying. In essence preserving

profits of one owner (or group of owners) may involve preventing others from accessing the same source of earnings, the imperative of restricted access. (Nitzan, 1998). Such practices both business and political are more important for business enterprises in rival activities or those planning to enter new markets.

By the time of independence in 1963, politics and economy was dominated by the European settler farmers. With independence there was a need to open up 'white' farms to African cultivators. However, this was complicated by the fact that some European settlers wanted to retain their stake in the independent Kenya. In what Wasserman (1973) describes as the 'independence bargain', the Kenyan Europeans adopted a strategy that ensured privileged Africans especially political leaders took over some of the European 'large farm sector'. These new landed Africans would oppose any radical transformation of the society. In industry too the new African leaders obtained equity shares in the multinational subsidiaries (Kitching 1980). Consequently, the post colonial government opposed nationalization of property. This continuity apparently was good as Kenya achieved satisfactory economic growth than countries like Tanzania that opted for radical changes. Land consolidation and Adjudication program which started in 1950's has ensured that the Agricultural sector is highly 'Kenyanized'. Most of the former European highlands with exception of tea plantations and some ranches have been purchased by political and administrative elite(Lofchie, 1994). Investment in agricultural land by the political elite has ensured that agricultural sector is not neglected. This system may have served Kenya well, but recent economic stagnation and increasing landlessness might be a threat. Some leaders such as Paul Muite, the Kabete Member of Parliament and Stephen Ndicho, the Juja Member of Parliament have been reported as instigating landless people to invade idle farmland . In May, 2000, the president

sacked his Assistant Minister Basil Criticos, a European of Greek origin whose land had been invaded, for claiming that the invasion was related to the Zimbabwean invasion of white farms. To quell calls for invasion of private land by squatters the in May, 2000, the head of the public service Dr. Richard Leakey warned politicians that they face prosecution if they incite landless people (Daily Nation, 27th May, 2000). Since large farms are also owned by the Kenyan elite, moves by politicians sympathetic to the landless are likely to meet opposition.

The pursuance of Kenyanization policy may have adversely affected non-indigenous businesses. According to one Kenyan policy document, "it is universally accepted that to maintain economic and political stability in any country, a significant portion of investments should be in the hands of nationals. .... However, it does not deny non-Kenyans effective participation........ It is consistent with the need to enhance entrepreneurial development and expanded investment in the country', National Development Plan 1989-1993, page. 153. In practice, Hibara (1994) notes that the term citizen or national has been equated with 'African'. For example, Nyong'o (1992) notes that during Import Substitution Industrialization (ISI) strategy in Kenya, local Indian owned foundries and metal engineering workshops operated at 23 per cent and engineering workshops at 34 per cent of capacities in 1983, yet the country continued to import machinery that could be locally produced. Local Indians (who are the local 'industrial' capitalists) are considered foreign by the political leadership and participate only as sponsors of power brokers. "The result has been that Kenyan compradors in power positions have been successful brokers of MNC subsidiaries and have left enterprising Asians cooling their feet in the corridors of power while their factories lie idle" Ny'ongo 1992, page. 41.

Business practices by companies concerned to maintain their market position that may require the exclusion of others is relevant in trying to explain the lack of deepening in national productive capacity. Most of Africa is a supplier of raw materials to the rest of the of the world. Raw materials acquire a substantial commercial value only when they are processed. Manufacturing value addition (MVA). Africa's MVA is less than one percent that of the world. The United Nations Industrial Development Organization (UNIDO) Director General Carlos Magarinos once observed : "If Africa can process just half of its agricultural produce into finished and semi-finished exportable goods, it can do a great deal to increase its income and improve the standard of living of its peoples while creating employment" (African Business, November, 1999).

In the industrial sector, most of the goods that are locally used such as fridges, cassettes, radios, cars and machinery are assembled from completely knocked down (CKD) kits of imported components. Companies in these activities limit their domestic economic activity to sales, marketing and distribution. Due to their global financial interests, local subsidiaries of multinational corporations often import these components from their parent companies and prefer to continue that dependence than shift to local sources. A shift to local sources would benefit a developing country more in terms of increased domestic output, employment, technology and savings on foreign exchange. Kenya assembles more than 40 models of trucks, busses and pick ups and imports 260 models of water pumps. Since many models are spread in a thin market it is uneconomical to produce parts domestically. A rational approach would require limiting the number of makes, models and designs, and achieving some standardization however, the importers and assemblers are politically well connected that any such move would meet serious opposition (Coughlin, 1992).

The Kenyan manufacturing sector is dominated by MNC's and Kenyan Asians. Some studies have found cases of restrictive business practices that limit industrial deepening. A study on 25 technology transfer agreements found that 36 per cent had tied import requirements and 32 percent had export restrictions (Coughlin, 1992 b). In another study, Low (1982) reports that 19 out of 34 foreign affiliated companies in a sample of 55 companies, had restrictions by their parent companies on seeking export markets. In some cases if the parent company posses capacity elsewhere subsidiaries do not upgrade their exports. Magadi Soda, despite operating in Kenya for more than 60 years had never considered producing caustic soda from the Soda mined from Lake Magadi.

Political corruption, that is, misuse of public office or responsibility for private or parochial gains has worked against the fiscal capacity of the state. The worsening of fiscal position has seen deterioration in the provision of physical infrastructure like roads, which is necessary if the private sector is to prosper. Controller and Auditor General annual reports of government accounts reveal many cases of political corruption. Based on these reports covering the period between 1990/91 and 1996/97, the Center for Governance and Development (CGD), a Nairobi based NGO estimated that the government had lost about US$ 4 billion through fraud and wasteful expending through payment of non-existent items or goods not delivered, irregular payments and un-surrendered or uncollected revenue (The East African, June 23, 1999). The 'Goldenberg Scandal' siphoned about US$ 200 million from the exchequer in payment as export compensation for exports that never occurred. This scandal involved senior government officials and private businessmen. Another serious financial scandal involved the National Bank of Kenya, the 4th largest bank which was exposed as bankrupt due to bad debts mainly going to senior government officials and politicians. This

indeed, undermines the capacity of the financial system to provide credit facilities to productive activities. For a detailed discussion on political corruption see Southall (1999).

1.3.0.3. Conclusion

The discussion in section 1.1.0 suggests that, from a social point of view, resources for investment have to be directed toward production and not merchant activities. On this ground, the Kenyanization program as initiated by MNC's in Kenya before independence and carried on by the post-colonial government has serious flaws. As long as the private sector remains more 'merchant type', the long-term productive capacity of the economy will remain weak. Perhaps the biggest challenge is for the government to harness the existing entrepreneurial capacity both foreign and domestic to increase national productive capacity, without hurting the confidence of the 'foreign capital' that dominate industry. The important choice would be not between indigenous and non indigenous enterprises but between productive investment and merchant activities. Public policy should discriminate on the basis of the latter. Providing better incentives for those firms that expand and upgrade their economic activities beyond merchant activities within national boundaries, irrespective of ownership should be the goal of public policy. It should be recognized that a non indigenous firm may contribute more to national development in this way than an indigenous owned Kenyan firm that remains 'stagnant'. For example, many American corporations are producing goods in Northern Ireland, Singapore, Taiwan which they export to the United States. About one-third of Taiwan's trade surplus with the US comes from US Corporations operating in Taiwan (Reich 1990). Local companies may also have difficulties in accessing foreign markets due to lack

foreign marketing and distribution networks, producing as Original Equipment Manufacturer's (OEM) supplier of foreign companies may be a strategic choice (Porter, 1990).

This section also has highlighted the importance of supporting institutions; financial system and strategic administrative management. Successful upgrading of the economy will hinge on improved management. Apart from tackling political corruption, it is necessary to establish institutions that are transparent, meritocratic and allow for continuity even when political regimes change to counteract the negative effects of politics of patronage.