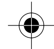

State-Private Sector Nexus in National Wealth Creation: A Framework for Analysis and its Application to Kenya

Dickson Khainga

Macroeconomics Division
Kenya Institute for Public Policy
Research and Analysis

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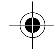

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Bishops Garden Towers, Bishops Road
PO Box 56445, Nairobi, Kenya
tel: +254 20 2719933/4; fax: +254 20 2719951
email: **admin@kippra.or.ke**
website: http://www.kippra.org
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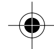
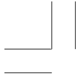
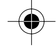
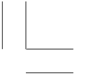


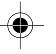
Abstract

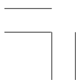
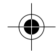
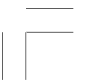
This study discusses a theoretical framework that is used to explore the interaction between the state and private sector. Three classes of businesses are identified, namely: makers or producers; traders/merchants or middlemen; and producers of financial services. Interactions between these three classes form a natural order in economics that can allow people to become wealthy without need for direction from the State. These three classes, together with the government, comprise a quartet that is key in national wealth creation. In terms of a national strategy for wealth creation, the businesses in the segments involved in 'production' are the strategic choice. However, there is no guarantee that government interventions or the institutional environment will favour this class of enterprises. Information on private sector and interactions with the Kenyan government is used to illustrate this framework. It is argued that despite market reforms some aspects of the institutional environment continue to favour those business classes in the distribution chain rather than the 'production' and is inimical to upgrading. Although the informal sector continues to receive wide policy attention, based on this framework, only about 30 percent would qualify for a strategic public policy; for the rest, the best the government can do is to concentrate on the fundamentals.

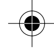










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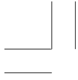
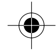
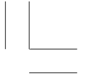
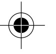
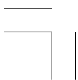
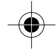
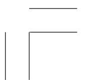
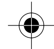








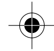






1. Introduction

The private sector plays a very important role in economic prosperity. Economic activities such as investment, jobs and overall output are driven by the private sector in the process of production and exchange of commodities. It is in this regard that in the mid 1980's, Kenya like many other developing countries started undertaking economic reforms focused on improving the overall policy environment for private sector development. Overall, economic reforms have aimed at ensuring macroeconomic stability, liberalization and deregulation, and privatization; all geared towards removing market distortions so as to unlock the potential of the private sector (World Bank, 1994). In Kenya, the private sector controls more than 80 percent of Gross Domestic Product (GDP) and accounts for about 63 percent of employment in the modern sector of the economy (Government of Kenya, 2005). The informal sector accounts for more than three quarters of total recorded employment. The Government of Kenya recognizes that the private sector is key to economic recovery and growth, and calls for redefining the role of the state to facilitate private sector growth and investment (Government of Kenya, 2003: 12). Accordingly, in 2005 the government initiated the process of developing a Private Sector Development Strategy.

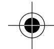
Policies aimed at fostering growth can be classified in two broad groups: fundamentals and selective interventions. The fundamentals relate to the critical public goods, which include: macroeconomic stability and a non-distortionary policy environment, investments in basic social services and infrastructure, openness to foreign technology, and rule of law. Selective interventions are those policies that target certain segments of the economy and include selective promotion, directed credit and industrial policy (World Bank, 1993b, 1997). The neo-classical view or conventional approach emphasizes the fundamentals. This



approach emphasizes the need to address costs and risks associated with private sector investment as well as barriers to competition that benefit all firms equally. Selective state interventions aim at giving specific or selective privileges and or support to particular businesses or activities that are considered growth-enhancing (World Bank, 2005b). Selective interventions pose more challenges because usually the government may lack adequate information for efficient resource allocation and could be driven by political rather than economic criteria or considerations. Nonetheless, most governments go beyond the basics. In Kenya, the post-colonial government engaged in active interventions in the economy aimed at addressing real and perceived imbalances created during colonialism. The government pursued 'Kenyanization or indigenization', which involved provision of selective privileges and creation of economic institutions biased towards African Kenyan enterprises as a means of developing the private sector. However, by 1989, the government conceded that the strategy had failed (Republic of Kenya, 1989). As discussed below, this epoch in Kenya's history produced a super-structure or institutions[1] that to a large extent continue to define the interaction between government and private sector and ultimately the path of growth.

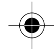
The conventional approach to the development of private sector is more informed by the profit-maximization motive of a firm. It is recognized that no private investment can continue without prospects for profits. Private sector activity can therefore be enhanced by creating an

[1] Institutions are defined here as the formal rules, laws and regulations as well as informal norms and values that provide the framework of interactions in a society. It also includes organizations created by the Government to support the achievement of particular objectives. Together with other constraints, they define the choices of the business persons in the quest to maximize returns on their investment. These decisions determine the allocation of investable resources, and, thus has important implications for growth of the economy.



environment where risks and costs of doing business are minimized. Economic policy reforms are therefore geared towards creating such an environment. In this neo-classical framework, it is assumed that self-seeking firms will contribute to aggregate material welfare as they employ factors of production to produce goods and services. However, not all economists agree with this approach. Some political economists have hinted to the need to understand the relationship between business enterprises or private sector activities and the material welfare of the populace. For instance, according to Veblen (1904: 286) '*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 businessmen*'. Thus, an environment where pecuniary interests of private investors are maximized is not a sufficient condition for maximizing material welfare or wealth of the society.

This paper attempts to develop a framework that tries to link the nature of business activities and growth of the economy, and the interaction between political and economic institutions in shaping incentives for the private sector and their implications for growth. The framework provides a means for ordering and interpreting information on private sector development, and to explore the key challenges inherent in pursuing a private sector-led growth strategy. The theoretical framework is discussed in section two. The framework identifies the interaction between the private sector and the government as a quartet that is a main force in wealth creation in a capitalist society. Section three provides a Kenyan case study focusing on the institutional super-structure that underpins interactions within the quartet. In section four, conclusions are drawn and the emerging policy issues provided.

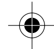


2. State and Private Sector Interactions in National Wealth Creation: A Theoretical Framework

The physiocrats[2] 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 – what they referred to as *laissez faire*. One of the leading physiocrats, François Quesnay, traced the creation and passage of wealth from one class of the society to the other, a flow he found to be circular and self-sustaining (Gide and Rist, 1915). Quesnay's analysis rested on the division of the society into three social classes: a productive class consisting mainly of agriculturalists and those in extractive industries; a proprietary class consisting of landed proprietors and those supported by them; and a sterile class constituting the rest of the population. According to the physiocrats, all exchanges were considered unproductive. On the contrary, Adam Smith underscored the importance of exchange and viewed wealth creation as a series of 'joint undertakings engineered by various sections of the society and linked together by the tie of exchange...All equally indispensable' (Gide and Rist, 1915: 61).

The appropriate role of the state in wealth creation still remains debatable. However, the kind of policies that can be pursued can be grouped into two broad categories as discussed in section one. According to the neo-classical view, once the basics or fundamentals are in place, self-seeking behaviour among firms will produce the highest level of social welfare. However, not all economists agree with the neo-classical view. According to Wade (1990), the list of functions of the state in the neo-classical orthodoxy becomes controversial when it comes to recognizing market failures, such as may occur in technological development, personnel training and incomplete markets,

[2] A group of 18th century French economists whose doctrine was that farming and extractive industries were the key to creation of national wealth.



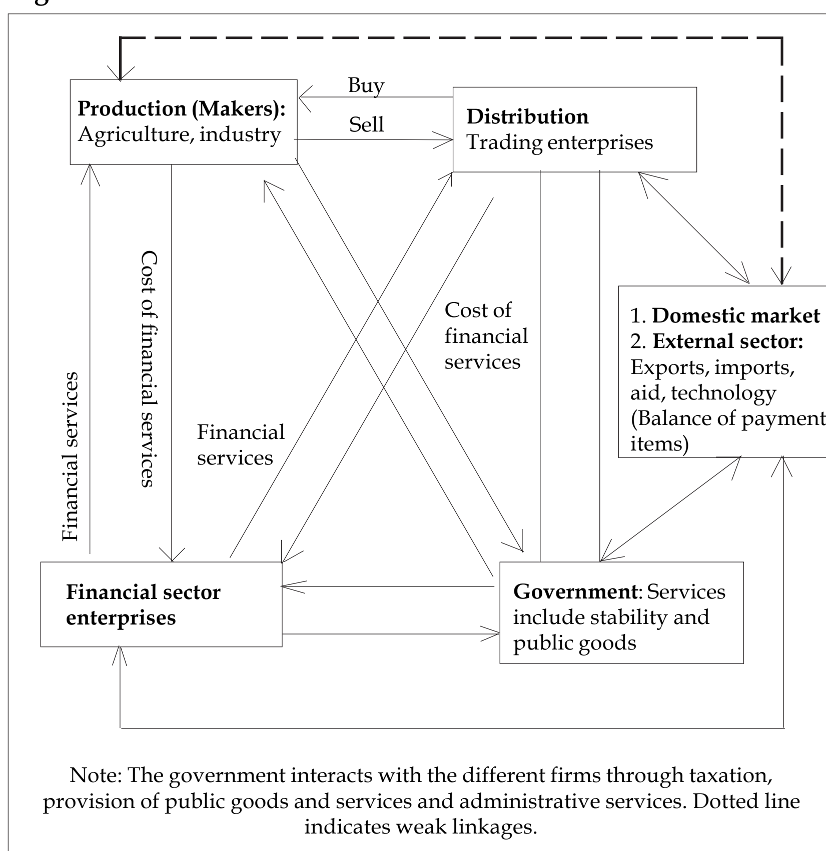
and deciding on what should be done. Market failures are known to arise when self-seeking individual actions produce outcomes that are socially-undesirable or are sub-optimal. The controversy on the role of the state has been complicated further by lack of consensus on the role of the state in the rapid growth and transformation of Japan and the Newly Industrialized Countries (NICs) of East Asia. In the interpretation of the growth of post-war Japan and the East Asian NICs, there have been two perspectives, one emphasizing a developmental government (interventionist) and the other emphasizing market forces (Friedman 1988; World Bank, 1993). Some scholars have argued that the NICs used selective promotional policies coupled with standards and performance requirements or 'reciprocity' from firms, such as export targets and local content (Wade, 1990, 1992; Yanagihara, 1994; Perkins, 1994; and Lall, 1995). The East Asian NICs engaged at sometime in selective promotion of domestic producers mainly in heavy industries and in electronics and semiconductors. However, a World Bank study concluded that "*promotion of specific industries generally did not work and therefore holds little promise for other developing economies*" (World Bank, 1993b: 354).

In developing our theoretical framework, we do not treat the private sector as a single block entity. Rather, we view the private sector as composed of three broad classes or groups of businesses that are fundamental to the theory of economic growth. These are: producers (makers); traders/distributors or middlemen; and producers of services, especially financial services.[3] These three classes, together with the government, comprise a quartet in the creation of national wealth or exchangeable values and its distribution within the society.

[3] There are other services such as: food service, leisure, travel, cleaning, advertisement, transport and other general business-related services. The basic assumption under the framework discussed here is that all these services are largely dependent on the performance of the three business groups as much as they support them.

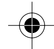
The interactions between the three business classes of enterprises constitute the natural order in economics, which can lead to prosperity without outside intervention.[4] Classical economists recognized the spontaneity of these institutions. In an often-quoted phrase from Adam Smith, there is a certain propensity in human nature to truck, barter and exchange one thing for another. 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

Figure: Creation and flow of national wealth



Note: The government interacts with the different firms through taxation, provision of public goods and services and administrative services. Dotted line indicates weak linkages.

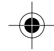
[4] What this implies is that a society made up of producers, traders, and financiers through interactions among themselves could become wealthy without state intervention.



and purity of such coins as already in circulation' (Gide and Rist, 1915: 71). The creation and flow of wealth within the quartet can be depicted schematically as shown in figure 1.

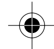
The three groups/classes of businesses employ factors of production to produce goods and services that are consumed by individuals, other firms and the government. The groups are identified on the basis of production relationships and are closely linked to the natural order in economics, first identified by the physiocrats. Whereas the classical Marxist literature identifies two classes in society, that is, *bourgeoisie* and *proletariat*, this framework identifies three different classes that comprise the private sector. Under production, we have those businesses in agriculture and industry. Agriculture in this case is considered in a broad sense to include: fishing, forestry, mining and quarrying, and plant and animal production. The firms involved in agricultural activities produce 'crude' products. Industry involves further processing and manufacture of consumer and industrial goods. The second segment of businesses and associated enterprises comprise traders/merchants or middlemen. These are businesses investing on goods and services (exchangeable value) in transit between producers (agriculture, industry and services) and consumers. They accumulate wealth through buying and selling, pure brokerage or agency services. The third group constitutes financial sector enterprises. Apart from accumulating resources, financial sector entrepreneurs facilitate the process of accumulation by providing financial services to other entrepreneurs, households and the government. As mentioned above, the interaction between producers, distributors and financiers forms a natural order in economics that may lead to prosperity without direction from the state.

Figure 1 basically represents the modern capitalist mode of production. This mode of production coexists and interacts with the informal sector.



This sector, which is largely unregulated and unplanned, comprising of commodity producers, traders and service workers operates outside state regulation. This sector is estimated to account for a large share of employment in Kenya. The interaction (naturalism) noted above may also be observed in this informal sector between informal money-lending activities such as rotating savings and credit associations (ROSCAs), friends and relatives, peasant farmers or *Jua Kali* (owners of informal micro-enterprises) and merchants (small retailers–*Dukas*) and hawkers–in rural and urban areas). Through the production and exchange of goods and services amongst themselves, they can become wealthy without any need for state intervention or direction. There are historical accounts of such activities in Kenya (see for example Lamphear, 1970) on the pre-colonial Akamba trading region). The greatest challenge is to create a proper institutional framework that can allow these enterprises to transform and upgrade in terms of products and technological advancement.

Most of the market activities in the informal sector provide a semblance of 'perfect competition', as barriers to entry and product differentiation are relatively minimal. Competition in this sector is intense to the extent that accumulation or profit is relatively low. Some of the activities in the informal sector are simply for economic survival, while there are those who engage in *Jua Kali* to supplement incomes from formal employment. However, within this informal sector, there are small-scale activities that have the potential for growth and upgrading (ILO, 1995). The majority of the enterprises that are small and stagnant with low productivity may not produce the dynamism required to spur growth. In addition, most of the commodities produced in this sector have a low-income elasticity of demand, such that as incomes grow, less and less of the goods produced in this sector are consumed. Due to these reasons, coupled with weak performance in the modern

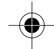


capitalist sector, the 'working poor' are ubiquitous in the sector, although the sector constitutes a large share of employment.

In terms of a national strategy for wealth creation and economic growth, businesses in the segments involved in production (makers) are the strategic choice, such that public policy should be directed towards providing a supportive environment. Although this may seem obvious, the institutional environment in Kenya has tended to favour businesses in the distribution chain. Merchant/middlemen businesses may move to become 'producers' but as we discuss below, institutional constraints and other incentives/disincentives may bias private sector investment choices to trading/middlemen activities because of the high pay-offs.

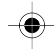
The strategic importance of 'makers' can be justified from the point of view of technological advancement, value addition, employment generation, tax base and productivity. This class of businesses produce the exchangeable value upon which the merchants or middlemen businesses operate. If enterprises in the producers segment can upgrade, then national wealth and progress is enhanced. For those enterprises in trading activities or middlemen, they do not have direct control over the volume and quality of the goods and services produced. Consequently, productivity improvement, learning by doing and technological advancement is limited. However, they serve an important role in wealth creation in terms of reducing transaction costs[5] between the producers and consumers, especially where information asymmetry and transport costs are high and/or certain institutional constraints impede direct interaction between producers and consumers. In addition, they reduce the risk faced by the producer in

[5] Technological developments such as the Internet are seen by many as a means of reducing transaction costs by facilitating the direct interaction between the producer or supplier and the consumer.



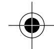
disposing their output. However, in terms of national strategy, if economic institutions are designed to favour businesses thriving in the distribution segment at the expense of producers, this presents an inefficient institutional arrangement in terms of increasing the national wealth. In economics, all the three groups or classes of businesses are producers as they employ factors of production to produce goods and services for sale. It can be shown that, if the production function of the 'producers' is more socially productive than that of the 'middlemen' (traders), a redistribution of economic power to the 'producers' coupled with supportive institutional framework and organizations would lead to a higher aggregate output. In other words, the institutional arrangement affects the aggregate supply curve of the economy or the capability of the economy to produce goods and services.

Interaction within the quartet takes place within a social, economic and political institutional framework – 'rules of the game' - formal and non-formal. Businesses react to both these non-market signals as well as the market signals when making investment decisions. Thus, the institutional matrix determines what kind of activities have the greatest pay-offs. However, institutions in a society are known to be influenced by those with the greatest bargaining power or political clout yet there is no guarantee that conflicting interests of self-seeking groups or classes will result in socially-efficient institutions. Economic institutions such as taxes, administrative regulations and supporting organizations, patent and copyright rules, tariffs, legal monopolies, cartels and exclusive contracts that form the institutional matrix may be designed in favour of particular groups in the society, yet they may not be organized with an incentive structure that aims at producing the greatest aggregate gain for the society. As Douglas North notes: *"Institutions are not necessarily or even usually created to be socially efficient; rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to create new rules... "* (North, 1994: 360-



61). Thus, institutional capture may occur as rules are created to serve the interest of particular segments of the society rather than serve the best interest of the society as a whole. In such a case, quoting (Goldsmith, 1998), Kimuyu (2000) argues that the state fails to be a steward of national interest and intervene to benefit special or well connected individuals. In a market economy, the state will thus support the market outcomes favoured by vested interests. This theoretical framework recognizes that the private sector is made up of different groups or classes whose interests may be conflicting. Those with the greatest bargaining power may tilt economic institutions and policies in their favour and this may not necessarily be the best for the society. State interventions within the quartet may thus not be reinforcing the synergies. They may drain society resources for the benefit of special groups.

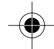
The literature on competitiveness suggests that firms should upgrade or move from simple to advanced/complex products or technologies. To achieve high productivity, firms must be able to boost production efficiency, quality of their products, improve product technology and/or apply new combinations. Productivity and constant improvement are central in theory of *Competitive Advantage of Nations* (Porter, 1990). Firms may move up the value chain from simple assembly to manufacture of critical components and even to invention. The United Nations Industrial Development Organization (UNIDO), in the Industrial Development Report 2002/03, gives a number of cases of catching-up or upgrading by firms in different countries. In East Asian economies such as Korea and Taiwan, firms moved from assembling to Original Equipment Manufacturers (OEM) to the production of own brands. According to the report, for instance, enterprises in Taiwan, Republic of China '*moved from the manufacture of transistor radios to calculators, to televisions, to computer monitors, to laptops and now to Wireless Application Protocol telephones*' (UNIDO 2002:105). However,



upgrading should be seen as a comprehensive societal process and, thus, should involve enhancing the factors of production upon which the enterprise relies on in the production process as well as the overall institutional environment.

The firm/enterprise-based theories of economic development are not new. Schumpeter (1934) described an entrepreneur as the 'fundamental phenomenon' of economic development, the 'innovator' causing 'creative destructions'. 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 central idea in the enterprise-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 cannot be explained without reference to business enterprises in the economy, their effects and the factors that impact on them. For instance, 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 such as Mitsubishi, Hitachi and Toyota. The rapid ascent of Korea is more explained by the activities of industrial groups such as Daewoo, Samsung and Hyundai.

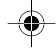
In the context of globalization, the framework discussed here can be understood from the point of view of 'shallow integration' and 'deeper integration' (Radosevic, 1999). 'Deeper integration' is characterized by production networks and technology accumulation while 'shallow integration' relates to trade 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. Although diversification of high technology production by Transnational Corporations (TNC's) has been taking place, especially



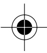
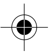
to the Newly Industrialized Nations of East Asia, through 'sourcing', sub-contracting and OEM's (Original Equipment Manufactures), these production activities are still limited in Kenya. Consequently, Kenya remains largely 'shallowly integrated' in the world economy.

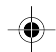
In the schematic presentation (Figure 1), the external sector is included to account for an open economic system. Foreign trade is important in the process of wealth creation; part of domestic output is exported to the rest of the world and what is not produced locally can be imported. For developing countries, imports of machinery and technology are important in enhancing domestic production. Competition from foreign producers is also important in disciplining local producers. Foreign borrowing, aid and investment have potential of enhancing the capacity of the economy in creating wealth.

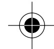
Within the quartet, the interaction between government and the financial enterprises has received a lot of attention in structural adjustment economic reform programmes (World Bank, 1994). Basically, financial liberalization, effective supervision and enabling legal framework for financial enterprises such as banks is now widely understood as necessary for economic development. These reforms have been mainly advocated to address weak financial institutions and 'financial repression' in developing countries. 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 Bank, 1993a; African Development Bank Report, 1993, 1997). The consequences of financial repression, it has been argued and sometimes empirically confirmed (see for example Seek and El Nil, 1993) reduce the flow of funds to the formal financial sector, distorts allocation of financial resources and thus undermines savings, investment and growth. Another important issue about the interaction between government



and financial enterprises that economists often point out is 'crowding out'. If the government borrows excessively from the financial sector or runs unsustainable deficits, the resources available for lending out to the private sector are diminished or the cost of credit to the private sector may increase. These ideas have been integrated in financial reforms in most developing countries. The interaction between the government and the other business classes, especially those in distribution, has not received similar attention.



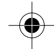


3. Application of the Theoretical Framework

In this section, the Kenyan case is used to illustrate the framework discussed in section two. The framework is used to order and interpret information on the development of the private sector in Kenya. An overview of the Kenyanisation programme is provided as a bridge to understanding the current structure as well as some of the challenges facing the private sector. In addition, although the implementation of Structural Adjustment Programmes (SAPs) has eroded some of the institutional biasness against 'productive' activities, we explore some of the persisting institutional barriers. Some of these institutions continue to define interactions within the quartet, thus impacting on some of the investment decisions or choices of the private sector players.

3.1 Kenyanisation and the development of private sector in Kenya

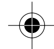
This section briefly reviews the development of the private sector in Kenya. It is done in an historical framework as a bridge to understanding the current structure of the private sector as well as the economic institutions that have defined the interaction between state and the private sector. At independence 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. In agriculture, the most productive land was in the hands of White settlers. The post-colonial government wanted to increase the control over the economy by the majority Africans but was also concerned about retaining the capital owned by non-indigenous Kenyans. The government, thus, sought to support African businesses 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 local entrepreneurs. Within the agricultural sector, the government set up marketing boards that controlled purchase and distribution of agricultural produce. 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 were established. The government also set up the Kenya National Trading Corporation (KNTC) as a state corporation having monopoly in the distribution of goods within Kenya, and 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 businesses that were dominated by European and Indian trading houses.

Trade licensing was also used as a means to achieving indigenization. In 1967, the government passed the 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. Hibara (1994) notes that the term 'citizen' was equated with 'African'. Some years before independence, many foreign companies concerned about the rise in African nationalism had started carrying out Africanization programmes by appointing Africans as their retailers and wholesalers. Foreign companies such as British American Tobacco (BAT), East African Breweries, Elliots Bakery, Bata Shoe Company, the Unga Group, and Schweppes had already initiated Africanization of their distribution networks (Leys, 1974, Swainson, 1977). According to Leys (1974), these African merchant businesses later formed the ruling class and important allies of multinationals.

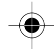
It is important to emphasize here that the post-colonial government sought to control production indirectly through price controls, licensing and distribution systems through the marketing boards and the Kenya



National Trading Corporation. In essence, the new government was extending the Africanisation policy initiated by the foreign companies immediately before independence. In this regard, for most producers, the provision of inputs and collection and distribution of their produce was conducted by different structures that were mainly state-supported or controlled. As discussed below, although deregulation and liberalization reforms have diminished the importance of these organizations and institutions, they have not been fully dismantled in all sectors.

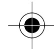
The government also established institutions to support industrialization. These include: Development Finance Company of Kenya (DFCK), Industrial and Commercial Development Corporation (ICDC), Kenya Industrial Estates (KIE), and Kenya Industrial Research and Development Institute (KIRDI). Ikiara (1988) notes that these institutions had not been effective in fostering industrial development in terms of developing linkages with the rest of the economy, upgrading production and use of appropriate technology. In addition, the government failed to use its procurement system effectively in promoting industrialization.

Despite government efforts to Kenyanize, it had become clear by 1989 that indigenous capitalism had failed to make headway in commerce and industry and still remained subordinate to non-indigenous capitalist and or entrepreneurs. Most of the state agencies that had been set up to promote African businesses ran into serious financial problems because of corruption and poor management. The National Development Plan (1989-1993) 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...” (Republic of Kenya, 1989: 153). According to the Development Plan, non-indigenous Kenyans constituting 2 percent of the total population controlled more than 65 percent of total turnover in manufacturing and trading activities by 1989. Kenyan Africans have constituted mainly merchant entrepreneurs within the distribution system. The majority are distributors, wholesalers and small-scale retailers. The type of businesses at the wholesale and retail level compares to perfect competition since almost everybody sells the same product. As a result, the level of accumulation is very small. Indigenous entrepreneurs dominate the *Jua Kali* sector. However, more than 70 percent of these activities are found in trade or ‘middlemen’ activities, while manufacturing and services each comprise about 15 percent of all the economic activity in the *Jua Kali* sector. According to survey results of micro and small enterprises conducted in 1999, within the informal sector itself, more than two thirds of employment is generated within trade and ‘non-producer’ services (CBS, ICEG and KREP, 1999).

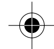
Within the agriculture sector, the transfer of land to native Kenyans benefited agricultural production immensely, especially through the expansion of land under cultivation. Over the period 1964-1971, agriculture grew by about 4.2 percent per annum. Over the same period, manufacturing grew by 8.2 percent with import substitution giving good results. This growth during the first decade of independence was not fully sustained. Analysis of the GDP figures reveals that over the years, the volume and value of goods produced within the economy was increasing at a decreasing rate, thus explaining the dismal performance. By early 1980’s, it had become clear that the forces driving growth in the better part of the first two decades of independence would no longer be sustained and thus structural reforms were necessary. Agricultural production would no longer be simply sustained by increasing acreage but through increased productivity. Likewise, industry would not thrive through import substitution behind



trade barriers but through competitive production that would meet international standards. The government, with the support of the IMF and World Bank thus initiated economic reforms within the framework of structural adjustment.

The liberalization, privatization and deregulation that followed saw the end to an active role by agricultural marketing institutions. As noted above, most of these institutions were poorly managed and were not providing effective services to producers to increase quantity and quality. The void left by marketing boards was filled by 'middlemen' and agribusiness companies in the purchase and distribution of agricultural inputs and output through contract farming. Contract farming in agriculture involves an agribusiness company integrating backwards from pure marketing to providing inputs and services to smallholders for production purposes and delivery of the output to the company. This is true for key commodities such as tea, coffee, horticulture, sugar and maize seeds. Contract farming is also being practiced in tobacco and barley farming.

In the industrial sector, most of the goods that are locally used, such as fridges, bicycles, motorcycles, cassettes, radios, cars and machinery are assembled from Completely Knocked Down kits (CKD's) of imported components. Domestic upgrading would require that, gradually, some of the critical components of the CKDs are locally manufactured. According to Coughlin (1988) a rational approach would require limiting the number of CKD models assembled locally and achieve some standardization. However, he notes that the importers and assemblers are so politically well-connected that any such move would meet serious opposition. Due to global financial interests, local companies may continue to import CKDs and prefer to continue to do that rather than shift to local sources. During the period of import substitution strategy, government policy was still biased towards trading activities, although the strategy aimed at deepening domestic



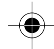
production. According to Nyong'o (1988) the government continued to import machinery that could be produced locally while locally-owned foundries and metal engineering workshops operated at below capacity. This view is also echoed by King (1996: 201) when he notes that there is lack of positive policy towards existing Indian engineering capacity, leading to under-utilization.

The discussion above serves to illustrate three important aspects related to the theoretical framework: First, the government policy framework focused on the distributive system as a channel for Kenyanization through marketing boards. Secondly, economic institutions were biased towards merchant activities. Thirdly, there was a weak administrative and institutional infrastructure in support of producers.

3.2 Existing institutional framework

Recent studies on value chain analysis of selected sectors in Kenya reveal several institutional constraints on the supply side of the economy that can be used to illustrate the framework discussed above (see for example, Global Development Solutions, LLMC™, 2004). The discussion in this section draws upon such studies, especially on pyrethrum, cotton, maize seed and coffee.

Pyrethrum is the fourth largest cash crop, with production having declined to about 12,000 tonnes from about 18,000 tonnes in early 1990's. The pyrethrum product industry remains weakly linked to domestic producers. Lack of competitively-priced pyrethrum from the Pyrethrum Board of Kenya (PBK) still remains a constraint, with some local producers sourcing pyrethrum from Tanzania. A value chain analysis conducted by Global Development Solutions (2004) found that administrative costs imposed by the Pyrethrum Board of Kenya in terms of cess, gunny bag depreciation charges, transport and Board service deductions as well as deductions by marketing agents have



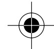
meant that the pyrethrum producer does not receive a price that is reflective of the market value of pyrethrum. Delayed payments are not uncommon. The value chain analysis also established that the tax regime favours importation of pyrethrum industry products to local value addition or production. This is the case for pyrethrum-based aerosol sprays whereby duty on the finished product is lower than that on the inputs that would allow for local fabrication.

Currently, Kenya produces about 30,000 bales of lint cotton against a potential of about 386,000 bales. The two key factors that explain this dismal performance are deterioration in the institutional support to cotton producers and importation of second-hand garments and fabrics. Over time, the trade in secondhand clothes has become a major economic activity, while the domestic textile industry has deteriorated such that any moves to tilt economic institutions in favour of domestic production faces difficulties. For instance, in 2005, the increase in tax on *mitumba* (secondhand clothes) from Ksh 20 per kg to Ksh 60 per kg with the implementation of the East African Customs Union protocol on Common External Tariff (CET) was met with serious protests from importers, wholesalers and retailers of *mitumba*[6].

Coffee production has been undergoing reforms. However, one of the key institutional weaknesses within the framework discussed here is the mistrust between farmers, marketing agents and dealers. Apparently, the Government recognizes middlemen as a contentious issue[7]. The Coffee Act has now been repealed to offer farmers another window to sell their produce. The Economic Recovery Strategy (ERS)

[6] According to the official report of the proceedings of the East African Legislative Assembly (Wednesday, 9 March 2005), during the process of negotiations, the partner states agreed to tax *Mitumba* highly to protect and enhance the local industry.

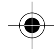
[7] On 3 April 2001, the then Minister for Agriculture, told Parliament that the government was reviewing the Coffee Act to address the issue of middlemen earning more than farmers (*Daily Nation*, 4 April 2001).



takes up the issue further in terms of improving the marketing system for smallholders, with a clear target of increasing 'the ratio of the small farmer price received and the auction price for coffee from 30 percent to at least 60 percent by 2006' (Government of Kenya, 2003: 103).

In the tea industry, the role played by the Kenya Tea Development Authority (KTDA) and now currently Kenya Tea Development Agency has not been without controversy. In 1998, a group of farmers allied to the Kenya Union of Small Scale Tea Owners (KUSSTO) and who felt that KTDA was exploitative instigated farmers to boycott tea picking for three months. The strike, together with a general desire to reduce government (de-regulation) involvement in the tea industry, contributed to the transformation of KTDA into a limited company. The mistrust between smallscale farmers, and the Kenya Tea Development Agency has not been resolved as was evidenced by another call for a tea picking boycott by KUSSTO in April/May 2006. A survey conducted by Nyangito and Kimura (2000) in Murang'a, Meru, Kisii, Kericho and Bomet revealed that middlemen play an important role in purchasing tea from smallholders and delivering to KTDA. Middlemen pay farmers lower prices than those offered by KTDA. The practice is common in Kericho area where it is locally referred to as '*Muringito* business' and in Kisii as '*Soko Uhuru*'.

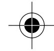
The agro-chemical industry is key to the competitiveness of the agricultural sector in terms of cost and availability of agricultural inputs. Although the marketing of key agricultural inputs such as fertilizers has been liberalized through elimination of import quotas and licensing, the institutional framework remains distorted, and thus favouring importation and hampering local formulation. Inputs that would allow cheaper local formulation are not exempt from import duty and VAT. The current import licensing of one-molecule-one-agent marketing is monopolistic (Global Development Solutions, 2004). Due



to inefficiencies in the distribution of fertilizer, Kenyan farmers pay more than twice the retail price paid in countries such as India and Sri Lanka for fertilizers such as DAP and Urea. About one third of the retail price over and above the FOB prices is accounted for by handling and distribution. The Pest Control Products Board (PCPB) has in the past not been able to effectively regulate the large number of distributors and stockists, leading to the sale of adulterated and pirated agro-chemicals to farmers.

As noted above, the institutional matrix encompasses the 'culture'. Discussions with most business people reveal the existence of an extensive class of 'shadowy traders', 'briefcase businesses', 'brokers' or middlemen. Most of them act as 'middlemen' between the producer and the final consumer. One key area that they are quite conspicuous is the transport industry in the form of matatu cartels. Matatu cartels operate in a way that entry in the industry is restricted to those who pay for the routes. This illegal practice thrived until a new government came into power in 2002 and introduced reforms. Although there are no estimates as to how much they exploit both the producer and consumer surplus, there are indications that they make substantial profits. It is not uncommon to see newspaper reports that hint on a continuing struggle between the two classes.

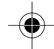
Additional cases may be used to illustrate this phenomenon. For instance, in the fish industry, a number of companies have agents that buy fish at the landing points on commission. Fish production could be enhanced if support could be provided to fishermen to acquire improved fishing gear. This may present a case for backward integration. Even in the maize sub-sector, the issue of merchant middlemen exploiting farmers has not been effectively addressed despite the governments policy to stabilize maize prices through the



National Cereals and Produce Board (NCPB)[8]. Delayed payments to farmers by the Board are not uncommon. In the maize seed sub-sector, a study conducted by the Ministry of Agriculture in collaboration with KIPPRA, Kenya Agricultural Research Institute (KARI) and Tegemeo Institute found that the Kenya Seed Company controls retail prices and trading margins within an institutionalized network of agents, sub-agents and stockists. The study concluded that shortening the marketing chain by eliminating sub-agents would contribute to lower seed prices. The study further found that Kenya has unfavourable retail to grain price ratio compared to countries such as Malawi, Zimbabwe and Zambia (Ministry of Agriculture, 2004).

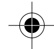
The sugar industry provides another case for illustration of the framework discussed in this article. Production revolves around sugar factories, which have until recently been majority government-owned. About 200,000 small-scale farmers are involved in sugar production in western Kenya and it is a main source of cash income. Until the early 1990's, companies provided input support to sugar farmers and purchased the sugar for processing. The efficient delivery of the support depended on the efficient management of the companies. In the past decade, the sugar industry was in a crisis, described by a government Taskforce on Sugar Industry Crisis as due to large scale mismanagement, corruption, lack of upgrading in production technologies and high cost of cane production. However, of interest to this paper is the change in policy by the government aimed at supporting the establishment of out-grower organizations to deliver inputs and services to farmers. This was justified on the grounds that sugar companies would concentrate on processing and marketing of sugar to improve efficiency. A Sugar Development Levy of 7 percent

[8] For instance, the Minister for Agriculture regretted that farmers were selling maize to middlemen at Ksh 800 for a 90 kg bag against the Board price of Ksh 1,200 (*The East African Standard*, 9 January 2006).



was introduced on sugar, both locally produced and imported, that would partly finance inputs and service delivery by out-grower institutions. The results of this new scheme were disappointing. A Government Task Force on Sugar Industry Crisis concluded, in part, that the out-grower institutions were acting as middlemen, making a markup on the services to farmers and were more expensive than when the services are provided by the factory. In addition, according to the Task Force, leaders of out-grower companies focused on securing access to public funds rather than service delivery. The delivery of inputs and other services has since reverted to the sugar companies. In the sugar industry, media reports and official documents hint on the struggle between producers and traders, mainly those keen on importing sugar. For instance, the 1997 *Economic Survey* (Government of Kenya, 2005: 132) attributes the depressed growth in sugar production to, among other factors, competition arising from diversion of sugar destined for neighbouring countries to local markets. Usually, all relevant taxes are not paid on such sugar, thus giving it pricing advantage.

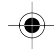
As discussed above, the informal sector plays an important role in job creation. For instance, while estimated total employment in the modern sector of the economy stood at 1.7 million in 2004, employment in the *Jua Kali* or informal sector was three times more at about 6 million during the same year. Although current data on the sectoral distribution of enterprises in this sector is not readily available, a *National Micro and Small Enterprises Baseline Survey* conducted in 1999 revealed that about two thirds of the enterprises were in the trade sector. The survey also established that the bulk of the MSEs had remained stagnant or had closed (CBS, ICEG and K-Rep Holdings, 1999). Despite a lot of policy pronouncements, formulation and implementation of the policies has been weak and haphazard (Ronge, Ndirangu and Nyangito, 2002).



From the framework discussed in this paper, only about 30 percent of the enterprises would qualify for strategic public policy support.

3.3 Public-private sector consultative process

Since the private sector is seen as the engine of growth, effective consultations between the public and private sector in policy formulation and implementation is imperative. This is important so that the private sector can provide a feedback on the policy environment and thus enable the government improve the policy environment while at the same time balancing national interests against the pecuniary interests of those who own businesses. A World Bank review of the public private sector consultative process reveals that although the consultative processes has improved with the NARC government, consultations in the past were mainly about lobbying for concessions and responding to specific issues rather than as a joint effort to address problems related to the regulatory framework (World Bank, 2005a). In addition to the existing institutionalized frameworks such as the Joint Industrial & Commercial Consultative Council (JICC), the National Chamber of Commerce & Industry (NCCI), Kenya Association of Manufacturers (KAM), The East Africa Association (EAA) and the Kenya Private Sector Alliance (KEPSA), the government has established the National Economic and Social Council (NESC). Experience from other countries that have used similar mechanisms point to the need for technical capability to make coherent policy from information supplied by the private participants as well as the inclusion of the broad segments of the society in public-private sector deliberations. The private sector is not only expected to provide inputs to the policy process but also to undertake an oversight function (World Bank, 1997).

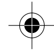


4. Conclusion and Emerging Policy Issues

One of the key aims of this study is to contribute to debate and research on the interaction between the state and private sector in explaining economic performance. The framework discussed in this paper advocates for a development strategy that puts the supply side of the economy at the center of public policy. It tries to identify some of the institutional factors that hinder the realization of the full potential of the economy. This framework advocates for the tilting of economic power from merchant/middlemen to those that embrace the productive ideal. Once economic power has been shifted to this class of entrepreneurs within a sound institutional framework, through their leverage as consumers, investors and savers, the growth potential of the economy can be enhanced. A number of important issues emerge from the framework of analysis :

1. Given the historical development of institutions in Kenya, there may be need to re-think the issue of what class of entrepreneurs should drive capital accumulation, including skills. In addition, though the ERS identifies 'productive sectors' as agriculture, industry and tourism, this framework suggests that within this 'productive' sectors there may be a need for a further dis-aggregation of the private sector players or classess and their role in national wealth creation;

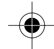
2. The answer to unlocking the full potential of the private sector may lie with facilitating administrative infrastructure and modes of organization that increase the economic power of producers or support 'production' of exchangeable values. These may include a review of the following: cooperatives, contract farming and sub-contracting, and the relevant legal and regulatory frameworks. Where weaknesses have already



been identified, such as in the case of coffee, cotton and pyrethrum, implementation of reforms should be enhanced.

3. The *Jua Kali* sector continues to receive wide policy attention. However, only a small section (about 30 percent) of the sector may be key for a national strategy for wealth creation. Many of the enterprises in *Jua Kali* represent a natural order in economic life. For this majority, the best the government can do is to stick to the 'fundamentals'.

4. The Africanization programme may have been driven more by political considerations in terms of ownership. However, this framework suggests that ownership is not key to economic prosperity but how well the business class strives to upgrade its products and technology in order to remain competitive. For instance, many American corporations are producing goods in Northern Ireland, Singapore and Taiwan, which they export to United States with about one-third of Taiwan's trade surplus coming from US corporations operating in Taiwan. This implies that foreign companies can effectively contribute to development if they can upgrade and integrate backwards.



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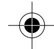

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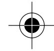

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