

Growth and Rent Dissipation: the Case of Kenya

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Poor growth performance in Kenya is rooted in the ruling elite's coalition-building to stay in power. To obtain loyal followers the public sector is over-manned. Dishonesty and rule-bending are allowed to develop within an administrative culture where politicians and top bureaucrats acquire private businesses and landholdings (straddling). Thus politics become coupled with corruption and particularistic business interests. We outline a stylized endogenous growth model to structure the discussion of why public sector surplus labour, corruption and straddling may be so harmful to economic growth in Kenya.

1. Introduction

Why is Kenya, and Africa in general, so poor? The notion of a natural sequence of stages of growth does not seem particularly helpful. Forty years ago Kenya was no poorer than many of the currently successful Asian countries. Differences in the savings and investment rates do not explain the gap in growth rates. Investment rates in South Asia and Sub-Saharan Africa were similar up to 1980, while growth performance

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diverged.² Neither do standard neo-classical growth predictions apply. Capital-poor Africa should offer a high marginal product of capital and new capital should be flowing in. In fact, we seem to observe the opposite phenomenon. The major difference between successful Asian countries and less successful African ones seems instead to lie in differences in the efficiency with which they use available capital. The returns to investments have been declining in Africa since the 1960s and in the 1980s came down to one tenth of the level in South Asia.³

With respect to the choice of capital equipment, poor countries are today largely in the position of imitators with a wide range of technologies to choose from. The question is why African countries are unable to apply Western technology in a way that is efficient. Application and adaptation do require skills and learning. But the level of education in Africa has been improved over the last few decades, although not as much as in the Asian NICs. Still, the education gap is not large enough to account for the difference in performance, although it is an important factor (see World Bank, 1993). It seems more reasonable to search for system-related factors like regulatory constraints and institutions to explain Africa's poor growth performance.

² The average per capita GDP growth rates were

	1961-73	1973-80	1980-92
South Asia	1.2	2.0	3.0
Sub-Saharan Africa	2.0	-0.1	-1.2

Source: World Bank (1994; 1989, p. 26).

In the World Bank (1993) study of the fast-growing East Asian economies, the authors estimate growth rates of LDCs and find that even when they control for education, investment and initial income level the African countries have a significantly lower rate of growth than the high-performing Asian countries. This suggests that the forces of convergence are not equally effective in Africa and that there are other distortions that slow down growth.

³ The returns to investments are simply measured as the growth of output divided by the level of investments, see World Bank, 1989, p. 26. Part of the African decline in the 1980s obviously was due to mismanagement of macroeconomic shocks.

Compared with Western democracies, the state in Kenya and in the rest of Africa has greater autonomy and tends to dominate civil society. Rulers need support, however, and Kenyan politics over the last decades has largely been concerned with the issue of coalition building. While a political economy approach is required to understand why certain institutions exist and why certain policies are pursued, a standard economic approach can be applied to derive their impact on economic development. Most of the present paper is devoted to the latter in a search for explanations of Africa's sluggish economic growth with Kenya as one example of many.

We first discuss some aspects of Kenyan political institutions. After setting the stage we outline a simple endogenous growth model with life cycle savings and technological spillover effects in order to structure the discussion of how important aspects of Kenyan political behaviour affect growth. We consider in turn the impacts of public employment as a loyalty device, bribes, straddling and rent-seeking investments. Finally, we provide some concluding remarks.

2. Kenyan Politics

Kenya is ethnically divided with the Kikuyu as the largest ethnic group. After independence in 1963 two parties or ethnic coalitions, KANU and KADU, emerged in Kenya.⁴ KANU formed the government and has remained in control since then even though the character of the ruling coalition has changed over time. Effective government requires a measure of respect and compromise among competing interests and between the political leadership and those governed (Hyden, 1992). According to Barkan (1992) a relatively robust governance realm was established under Kenyatta, but gradually dismantled under Moi. The 1992 elections do not seem to have been able to rebuild it.

Kenyatta's strategy was to couple loyalty with an ability to represent a public constituency within a semi-competitive political system. Local leaders were allowed to maintain their independent

⁴ Already in 1964 Kenya African Democratic Union (KADU) (the party that Daniel Arap Moi originally represented) was integrated in Kenya African National Union (KANU). With the demise of Kenya People's Union (KPU) in 1968 Kenya became a *de facto* one-party state. It did not, however, become a *de jure* one-party system until 1982. In 1992 there were again multiparty elections, although the realization of those has been questioned.

political support, provided they supported the regime. Almost any adult was allowed to run for parliament (within KANU). The competition for being re-elected forced the members of parliament to look after the interests of their constituents. Kenyatta also built patronage by his appointment policy. Ministers or assistant ministers received positions of prestige with access to state resources, which improved their chances of re-election considerably. Others were appointed to statutory boards, regulatory agencies, and parastatals, which meant access to a range of fringe benefits and to resources that could be used to build constituency support.

Kenyatta was committed to maintaining Kikuyu domination. Yet it was possible to preserve a relatively high degree of professionalism in both the civil service and the judiciary, since the Kikuyu is a large and relatively well-educated group. Patron-client relationships linked the state and civil society together and provided also for a measure of accountability. The Kenyan state in this period was to some extent predictable with relatively clear norms and procedures. Autonomous associations⁵ were allowed to exist as long as they did not challenge the presidency. They functioned as a counterweight to the state and as a link with civil society.

Much of this was gradually changed after Kenyatta's death in August 1978. The presidency was transferred to the then Vice President, Daniel Arap Moi. His position was less secure than Kenyatta's position had been. This insecurity became evident with the coup attempt in 1982. Moi thus needed to cement his position, and this was to have consequences for the policies to be pursued. Barkan (1992, p. 181) notes that

Moi did not view prominent elected leaders as people who maintained popular support for his regime, but as rivals who threatened it.

Thus powerful personalities were set aside and clientalist networks broken up in Moi's attempt to reduce the influence of the Kikuyu and

⁵ There were for example professional associations and groups of economic interest, church organizations, ethnic welfare associations and Harambee self-help groups.

increase that of the Kalenjin.⁶ Kikuyu businessmen were excluded from positions that provided inside information, easy access to loans, and new investment opportunities. The support to Kikuyu-controlled financial institutions was withdrawn. Interference in administrative and judicial systems increased and their independence declined. Public debate of government policy was discouraged. In effect, all independent sources of authority were eliminated during the 1980s.

During the 1990s the situation has changed again to a certain degree. Under pressure from donors as well as local opposition groups, President Moi had to accept multi-party elections at the end of 1992. These were formally democratic, but there have been widespread allegations about improper conduct. KANU managed to achieve a majority in Parliament (partly due to the split of the opposition), and since it was opened KANU has managed to entice several members of the opposition to defect to KANU. The partly eroded power base is thus being rebuilt, although it will probably not be possible to regain the same measure of control as in the 1980s.

When political power in this way is monopolized and the leadership is marked by abrupt changes of the rules of the game, the governance realm is seriously threatened. On the one hand, the reduction of the sway for voluntary associations strained the relationship between the state and the civil society. On the other hand, since it came to power, the Moi government has attempted to broaden its supporting coalition by rewarding its followers to cement their loyalty. This is still done by assigning jobs, licences, contracts etc, to followers who often do not meet the required qualifications.⁷ Without political competition, however, the beneficiaries have less commitment to further the

⁶ Kalenjin representatives came gradually to occupy many top positions in the state and in the parastatals. In the early 1990s half of the District Commissioners and 25% of all chairmen and chief executives were Kalenjin who in fact controlled 40 out of 85 profit-making public enterprises (Ngunyi and Gathiaka, 1992). Moi used branch organizations of KANU to break up the clientalist networks that existed when he took over. Moreover, ethnic groupings, such as GEMA, have been broken up. Moi also tried to capture the Harambee movement from above, and he tried to bring the 140 or so non-governmental organizations in the country under control by instituting a law requiring their registration. Bates (1988) shows how Moi used the threat of food shortage to broaden his political base by channelling resources into the grain growing areas to the benefit of political leaders in Nandi.

⁷ See Findlay (1990) for a discussion of the neo-patrimonial state.

interests of their constituency. Many of them use their political positions as a base for private economic activities (straddling). Together with associated groups in the bureaucracy, top politicians constitute the core insiders in Kenya with large private stakes in agriculture and in urban activities.⁸ Economically powerful individuals outside politics are often connected to the core group or act as front men for members of the core group.

Since the Kenyan government officially abides by the legal rules of the system, its legitimacy may be undermined if it too openly disregards them. Declining legitimacy requires increased repression to control the opposition. In Kenya rules are often bent to serve private particularistic purposes. Like most African states, Kenya has been characterized by extensive and persistent controls and regulations, that have been used by the group in power to generate revenue for themselves and their clients. This is an important reason why African governments have been so unwilling to undertake trade reform. Bienen (1990) notes that opposition to trade reform resides within the government's civil and military bureaucracies more than within groups outside the government.⁹ Extensive regulations and controls have also protected politicians' private businesses from competition and allowed for corruption and favouritism.¹⁰

3. The Growth Framework

In order to understand how coalition building, corruption and rent seeking in Kenya affect growth performance, we organize the discussion around a very stylized endogenous growth model with overlapping generations. The model focuses on investment incentives and technological investment spillovers between generations. For similar models see Persson and Tabellini (1994), Alesina and Rodrik (1994) and the overview in Hammond and Roderiquez-Clare (1993).

⁸ There are widespread allegations that public property such as land is being sold below market prices to well-connected individuals, see e.g. 'Assault on Graft', *Weekly Review*, 23 June 1993.

⁹ The waivers of import taxes, etc., have been costing a high fraction of the potential revenue in Kenya. There has been some caution with these waivers, since some flagrant examples were revealed in the press.

¹⁰ It should be noted, however, that since 1993 steps have been taken towards economic liberalization.

Consider an investor j who lives for two periods. When young he earns an income y_{t-1}^j which he allocates between consumption c_{t-1}^j and investments (savings) k_t^j . The marginal return on investments is r_t . When old, the investor consumes z_t^j equal to his capital incomes and savings. The budget constraints of investor j are

$$(1) \quad y_{t-1}^j = c_{t-1}^j + k_t^j$$

$$(2) \quad z_t^j = (1 + r_t)k_t^j$$

All investors have the same preferences

$$(3) \quad v_t^j = V(c_{t-1}^j, z_t^j)$$

which are assumed to be homothetic. The investor maximizes (3) with respect to k_t^j subject to (1) and (2).

With homothetic preferences the ratio of consumption in the two periods is a function of intertemporal prices only, or, since from (1) and (2) the budget constraint can be written $p_t y_{t-1}^j = p_t c_{t-1}^j + z_t^j$, we have that

$$(4) \quad \frac{z_t^j}{c_{t-1}^j} = D(p_t)$$

where $p_t = 1 + r_t$ is the relevant intertemporal price (returns on savings) and $D' > 0$. Moreover, optimal behaviour of investors also implies a common saving rate for all investors, since by combining (4) with (1) and (2) we obtain

$$(5) \quad k_t^j / y_{t-1}^j = D(p_t) / [p_t + D(p_t)] \equiv s(p_t).$$

We cannot in general determine the sign of $s'(\cdot)$ as substitution effects and income effects may diverge. The most realistic case, however, is the one where $s'(\cdot) > 0$.

Production takes place according to the production function

$$Y_t = (e_t M_t)^\eta K_t^{1-\eta} \quad \text{with } 0 < \eta < 1$$

where M_t is the number of individuals in productive employment, e_t their average skill level, and K_t is total capital which is assumed to last for one period. The marginal return on investment is

$$(7) \quad \frac{\partial Y_t}{\partial K_t} = (1 - \eta) \left[\frac{e_t M_t}{K_t} \right]^\eta = r_t$$

Thus labour's income is ηY_t . Since in our set-up only the young save, aggregate (gross) savings are $s(p)\eta Y$ and we have

$$(8) \quad K_t = s(p)\eta Y_{t-1}$$

We are convinced that there is a significant potential for technological learning and other kinds of endogenous productivity enhancement in the production processes of most LDCs. How best to capture technological spillovers is an empirical question where solid knowledge is not easily obtained. Here we adopt a simple spillover mechanism where the potential labour productivity of the present generation, $e_t N_t$, depends on past production

$$(9) \quad e_t N_t = h Y_{t-1}$$

where h is a positive constant and $N_t \geq M_t$ is the total labour force. Alternative formulations to (9) would yield conclusions that differ in details, but not in essence from that derived below. Finally, we assume a constant fraction of productive workers to the total labour force, $m = M_t/N_t \leq 1$.

By inserting (8) and (9) in (7) we see that the model now defines a constant return on investments $r_t = r \equiv p-1$ which must satisfy the equation

$$(10) \quad (1 - \eta) \left[\frac{hm}{\eta s(p)} \right]^\eta = p - 1$$

Moreover, from (6), (8) and (9) we find that K_t and Y_t must grow at the same constant rate equal to

$$(11) \quad g = (hm)^\eta (\eta s(p))^{1-\eta} - 1$$

This is the stylized set-up to be used as we now explore how political behaviour affects growth in Kenya.

4. Public Employment as a Loyalty Device

As mentioned, the ruling group in Kenya tries to build and maintain a sufficient power base to remain in office. This is partly done by hiring a large number of civil servants who are dependent on and therefore loyal to the regime.¹¹ Expanding the public bureaucracy is thus an important part of the coalition-building efforts of the ruling elite in Kenya.

What are the implications of public employment for the long-term economic development? Returning to the model of the previous section, the answer to this question depends in part on how the public resources are utilized and in part how income earners in the public sector use their incomes.

If resources in the public sector are used for productive purposes with the same efficiency as in the private sector, m in (11) remains unchanged as employment is reallocated from private to public sectors. More realistically, however, efficiency is impaired as the ruling elite allocates resources to public institutions to their own benefit. In fact, excessive recruitment may be considered one of the most serious flaws in public administration in many LDCs (Gelb *et al.*, 1991). This is also the case of Kenya where parts of public employment constitute surplus labour. The role of government employment in politics has caused the share of non-personal spending in the recurrent budget to fall from over a third ten years ago to about a fifth now.¹² Some activities do provide public services which help preserve popular support for the government. But the ultimate goal is to sustain the position of the ruling coalition with little attention being paid to productivity. When the public sector is led in this way by distributional rather than efficiency considerations, productivity easily goes down as the public sector expands and attracts skilled workers away from private enterprises. As a consequence the parameter m in (11) is less than unity, and lower the higher the public employment rises. While this type of x-inefficiency is detrimental to (steady state) growth (less is produced in every period which again dampens productivity growth

¹¹ Gelb *et al.*, (1991) emphasize that surplus labour in the public sector is a characteristic of many developing countries. Of the increase in the total wage labour in Kenya in 1963–85 two thirds were public sector hirings.

¹² See World Bank (1992, p. 39) and Bigsten (1992, p. 21).

via the spillover mechanism), it would only have reduced the steady state level of income per capita in a Solow model without spillovers.

Moreover, in our framework growth may be affected by the fact that the Kenyan government often recruits educated people who could otherwise become a politically threatening group.¹³ This selection of people may reduce the average productivity growth in the private sector, h in (9), and the growth rate defined by (11) declines as long as public sector surplus labour is biased towards high skills.

Let us then turn to how the public sector uses its incomes. As we will discuss more carefully in Section 6, politicians and civil servants may care less about productive investments than private agents because they, as political insiders, face investment opportunities abroad or in domestic rent-seeking activities from which private agents are excluded. While politically motivated government expenditures always existed in Kenya, their scale seemed to rise in the 1980s and early 1990s. Extras have been added at the Permanent Secretary and ministerial levels. Politically powerful ministries have been spending beyond the budgetary limits. Part of the money has been used to finance parastatals that create employment slots to be allocated to clients. Executives are normally political appointees (sometimes with dubious credentials), and they earn high salaries and receive substantial perks. Since these enterprises are always bailed out by the government there is little incentive to be efficient.¹⁴ Because these activities are part of the patronage base they attract too great a proportion of investment resources.

To capture some of this let the fraction of insiders' savings that is invested elsewhere or unproductively be θ . Further, we assume that the public sector is financed by income taxes. The tax rate is denoted by α . With income taxes, equation (8) must be replaced by

$$(12) \quad K_t = s(p)[(1-\alpha)\eta Y_{t-1}] + (1-\theta)s(p)[\alpha\eta Y_{t-1}] = s(p)(1-\theta\alpha)\eta Y_{t-1}$$

and the growth rate becomes

¹³ The government often acts as an employer of last resort to Kenyan university graduates.

¹⁴ The World Bank (1992) estimates (very crudely) that resource use in the parastatal sector is so inefficient that annual economic growth could be increased by at least 2 percentage points were these resources transferred to the private sector.

$$(13) \quad g = (hm)^\eta ((1 - \theta\alpha)\eta s(p))^{1-\eta} - 1$$

Observe that when $\theta = 0$, the growth rate is unaffected by taxes. Thus if all income to the public sector is appropriated by political insiders, and if political insiders allocate their incomes between private consumption and productive domestic investment exactly like other private sector agents, the reallocation of incomes has no growth effects. In that case the costs of public sector surplus labour come via reductions in m and h only. Whenever $\theta > 0$, however, rents dissipate in the public sector. In this case taxes to finance public sector surplus labour reduce capital investments. As a consequence total production becomes lower and the endogenous productivity growth is dampened which again reduces the growth rate of total production. Or, formally, as (13) shows, the higher the value of θ and the tax rate α , the lower the growth rate.

It should be noted that we do not distinguish between insiders' savings invested elsewhere or unproductively even though foreign bank accounts pay interest (and contribute to future GNP) while cathedrals in the sand do not. However, as long as technological spillovers are generated from GDP only, neither contribute to economic growth. Thus if our set-up captures realistic features, capital flights are socially costly and the government should restrict individuals from saving abroad. This points to a channel through which corruption lowers economic growth (our next theme), by allowing some portion of private savings to be channelled abroad where no positive externalities are allowed.

5. Bribes

Taxes are not the only source of income to the public sector. Civil servants can supplement poor pay by collecting bribes from the private sector and other political insiders can accumulate substantial wealth from corruption. The extensive regulations and controls in Kenya offer wide opportunities to obtain income from corruption and favouritism. The collection of bribes can be viewed as an alternative way of taxing private enterprises with similar distortionary effects to those of a formal tax system. There are important differences between the two systems, however, that simply stem from the way in which the money is collected from the enterprises. Bribes to obtain the right to invest are

more harmful to growth than ordinary taxes on profits from investment.

In order to show this, assume that licences are required to invest and that bureaucrats grant licences only to those who pay a sufficiently high bribe.¹⁵ The fraction of bribes per unit of investment is denoted by β such that the budget constraint in (1) now becomes

$$(14) \quad y_{t-1}^j - c_{t-1}^j = (1 + \beta)k_t^j$$

where income tax is now set equal to zero ($\alpha = 0$). Combining (14) and (2) gives us the following budget constraint of an investor $p^c y_{t-1}^j = p^c c_{t-1}^j + z_t^j$ where

$$(15) \quad p^c = \frac{1+r}{1+\beta}$$

is the relevant intertemporal price in equation (4). Note that the net rate of return to investors is $(r-\beta)/(1+\beta) \equiv p^c - 1$.

Investment outlays, $(1+\beta)K_t$, are (as before) equal to savings, $s(p^c)\eta Y_{t-1}$, implying that (8) is replaced by

$$(16) \quad K_t = \frac{s(p^c)}{1+\beta} \eta Y_{t-1}$$

Let us first see how corruption affects the marginal productivity of capital along the steady state path. By inserting (9) and (16) in (6) we obtain

$$(17) \quad (1-\eta) \left[\frac{1+\beta}{\eta s \left(\frac{1+r}{1+\beta} \right)} hm \right]^\eta = r$$

As long as the fraction

$$\frac{(1+\beta)}{s(1+r/1+\beta)}$$

is increasing in β for each value of r (which is obviously the case in the most realistic case with $s'(\cdot) > 0$) we see directly from (17) that r is

¹⁵ Investment licences have been abolished in Kenya, but there are other licences and permits, which may be used in the same manner.

increasing in β as well. Hence, the marginal return of investments goes up simply because corruption leads to less investments along the steady state path. To find how β affects the growth rate we insert (16) and (9) in (6) and derive

$$(18) \quad g = (hm)^\eta \left(\frac{\eta s(p^c)}{1 + \beta} \right)^{1-\eta} - 1$$

where $p^c = (1+r)/(1+\beta)$. As long as the equilibrium value of r in (17) is increasing in β , we see from (17) that the equilibrium value of $(1+\beta)/s(p^c)$ must go up with β as well. This implies that $s(p^c)/(1+\beta)$ goes down, and the growth rate in (18) becomes lower the higher is β .

Let us now turn to the tax comparison. It is most relevant to compare investment bribes with taxes on investors' profits. We assume that profits are taxed with a rate γ such that equation (2) becomes

$$(19) \quad z_t^j = [1 + r(1 - \gamma)]k_t^j$$

Combining (19) and (1) gives us the budget constraint $p^T y_{t-1}^j = p^T c_{t-1} + z_t^j$ where

$$(20) \quad p^T = (1 + r - r\gamma)$$

is the intertemporal price with taxes on profits, to be inserted in equation (4).

There is no obvious way of comparing the two 'tax' regimes. One possible comparison (or illustration) is obtained by assuming that the two systems collect equal rents from the private sector if private agents earn the same incomes and face the same interest rate. This requires the intertemporal prices to be identical to both profit taxes and investment bribes, or $p^T = p^c$. When this is the case and the two systems have the same initial income Y_0 , it follows directly that first period consumption and saving levels must be equal as well:

$$(21) \quad s(p^T)\eta Y_0 = K_1^T = (1 + \beta)K_1^C = s(p^c)\eta Y_0$$

With bribes the collected rents in the first period are $G^C = \beta K_1^C$, which are equal to the (present value of) rents collected as profit taxes G^T , since

$$G^T = \frac{1}{1+r} \gamma r K_1^T = \frac{1}{1+r} \gamma r (1+\beta) K_1^C = \beta K_1^C = G^C$$

where we used (17), (16), (13) together with the equality $p^T = p^C$ and the hypothetical assumption that r is the same in the two cases.

Even though the two systems, in this way, are potentially able to tax the private sector to the same extent, they affect capital accumulation differently. As seen from (21), capital invested in the initial period is lower with bribes than with profit taxes, $K_1^C < K_1^T$. The difference also shows up in the long run growth rates. The growth rate of the profit tax system can be found by inserting $p = p^T$ in (11) to obtain

$$(22) \quad g^T = (hm)^\eta (\eta s(p^T))^{1-\eta} - 1.$$

As long as $p^T = p^C$, both ordinary profit taxes and bribes have the same distortionary effect on saving incentives. Yet, growth is lower in the corrupt case than in the ordinary profit tax system since from (18) and (22),

$$(23) \quad g^T > g^C.$$

The reason why bribes are more harmful to growth than taxes is that bribes constitute a wedge between money saved and capital put in productive use. While taxes are an *ex post* deduction of the revenues that accumulation of capital generates, bribes are *ex ante* deductions of the capital accumulated. The power of bureaucrats (and politicians) to obtain bribes depends on their credible threat not to grant the investment licence. Since legal enforcement is impossible, bribes have to be paid upfront. Thus for each Ksh not consumed only a fraction $[1/(1+\beta)]$ goes to productive investments. In this way bribes in period t have a similar effect as a tax on all income earners in the next period since the capital they will work with is directly reduced by the bribe money. When people earn less money they save less with a detrimental effect on productivity enhancement and economic growth. Even though the two systems may initially have the same taxing potential, bribes provide less money to the public sector than profit taxes (with $p^T = p^C$). This is because a lower growth rate gives lower incomes and therefore less savings to 'tax'.

There is, no doubt, a high degree of corruption in Kenya in connection with the issuing of licences and permits and in contract procurement. High bribes may help explain why growth is low in spite

of a relative high saving rate of on average 20% of GDP between 1972 and 1990 (Kenya, 1991).¹⁶ The growth formula in (14) does not, however, take account of the fact that some of the bribe money can be reinvested in the private sector. This we consider in the following section.

6. Straddling and Rent-Seeking Investments

Straddling means that the core group of political and bureaucratic insiders also invest in the private sector. Some of these investments are ordinary private sector investments, but not all of them. Parts of the investments are undertaken to widen the possibilities for rent appropriation in the future. Much government money has in recent years gone to sectors where the scope for kickbacks is particularly large.

One example of how straddling gives rise to rent-seeking investments, is when insiders establish consultancy firms that collect fees for 'consultancy services' in order to have certain contracts signed. Office building has been particularly popular¹⁷ and the development is best described as 'corruption-driven construction'. Banking is another example where the extent of non-performing loans gives an indication of the misallocation of credit due to political interference in the financial system.¹⁸ A minister with one of the 255 parastals under his control is for instance allowed to set up a bank or financial institution and order the parastatal to deposit its money there. The bank can then lend money to the minister, his firms or his associates who later default on the loans while the insolvent bank is bailed out by the government. On the surface the financial system in Kenya has been liberalized. In

¹⁶ World Bank (1992, p. 38). See analysis in Peterson (1991).

¹⁷ See particularly the discussion on the Turkwell Dam Project, where cost overruns were dramatic. Critics within the EEC have argued that the cost of the project became more than twice what it would have been if it had been tendered competitively. See *Weekly Review*, 23 July 1993 for a discussion of this and some other documented affairs.

¹⁸ According to a well-placed banker more than a third of banking assets were close to worthless in 1992.

reality it has to a large extent been taken over by politicians who use it to accumulate private wealth.¹⁹

The forms of rent-seeking investments in Kenya are so diverse that they are impossible to capture properly by one single model formulation. Let us nevertheless speculate a little on a possible relationship between corruption, straddling and growth. Since gains from corruption and other types of monopoly rents are included in the return on rent-seeking investments, the private profitability of these activities is clearly above the value to society. Whether rent-seeking investments produce anything of value for society or not, is not important for the conclusions to be derived. As long as these investments are less productive than ordinary investments we may simplify the presentation by assuming that rent-seeking investments are socially unproductive.²⁰

We first derive the effect of the reinvestment of bribe money neglected in Section 5. Thus we need to include savings of insiders which (in period $t-1$) are $s(p)$ times their income from bribe taking βK_t . Let us denote the fraction of insiders' savings that go to rent-seeking investments by θ . Insiders' savings for ordinary investments are then given by $(1-\theta)s(p)\beta K_t$. Added to private sector savings we obtain total productive investment outlays $(1+\beta)K_t$, or

¹⁹ It was reported in the *Weekly Review* (21 February 1992) that

Trade Bank and Pan African Bank ran into problems, because of non-performing loans made to companies owned by the former minister for energy, Mr Nicholas Biwott, whose liabilities to the banking system were reported to be in excess of shs 1.2 billion, with the two banks being the main creditors ... As a close study of ownership patterns of local financial institutions attests, most of these institutions are owned by groups of investors who have business associations with politically influential personalities, making it possible for them to operate with little regard for banking regulation ... The *Financial Times* report said that a number of locally owned banks were created in the 1980s with the support of senior politicians, who organized their funding through large deposits from parastatals.

See also *Financial Times* (1993).

²⁰ The case with a positive but smaller spillover effect from rent-seeking investments is easily analysed, but does not provide additional insights.

$$s(p)(1-\theta)\beta K_t + s(p)\eta Y_{t-1} = (1+\beta)K_t$$

Rearranging terms we obtain the following relationship between income and investment:

$$\left(\frac{\eta s(p)}{1+\beta(1-(1-\theta)s(p))} \right) Y_{t-1} = K_t$$

and we can calculate the growth rate with straddling to be

$$g^s = (hm)^\eta \left(\frac{\eta s(p)}{1+\beta(1-(1-\theta)s(p))} \right)^{1-\eta} - 1$$

where $p = (1+r)/(1+\beta)$. As seen the growth rate is higher the lower is θ , the rate of rent-seeking investments by political insiders. Yet corruption lowers the growth rate even when (i) $\theta = 0$ and (ii) the saving rate is independent of p . Thus in contrast to the case with tax incomes (discussed in Section 5), political insiders with the same investment behaviour as private agents do not neutralize the effect of rent appropriation from the private sector. In fact, corruption deludes savings and capital accumulation since bribe taking implies that a fraction β of private sector savings goes to political insiders who spend a fraction $(1-s(p))$ of what they receive on private consumption.

In addition, corruption and rent seeking-investments may crowd out more productive investments for two reasons. To see how, we have to discuss how the rate of rent seeking investment θ is determined. Let the (marginal) private return on rent-seeking investments be denoted by ϕ which is higher the higher the fraction of bribes in investments β . In addition, it is reasonable to believe that there are decreasing returns to scale in rent-seeking activities. The more money that are invested, relative to other investments, to capture rent-seeking gains, the lower the marginal rate of return on these activities. This is captured by assuming that ϕ depends negatively on the share θ of rent-seeking investments to total investments among insiders. Hence, we have $\phi = \phi(\theta, \beta)$ with $\phi_\theta < 0$ and $\phi_\beta > 0$. We wish to determine θ endogenously for a given value of β by considering how insider investors divide their investments between ordinary private activities and rent-seeking purposes.

Rent-seeking investments are attractive as long as ϕ exceeds the after-bribe returns on productive investments $(r-\beta)/(1+\beta)$. An interior

equilibrium is where θ equals the level that makes investors indifferent between the two assets on the margin, or where²¹

$$(25) \quad \phi(\theta, \beta) = \frac{r - \beta}{1 + \beta} \equiv p^s - 1$$

where $p^s = (1+r)/(1+\beta)$. By considering (25) we first see that a higher β may lower the rate of returns on productive investments both because profits per unit invested ($r-\beta$) may go down and because the unit investment outlays, $(1+\beta)$, increases. Second, a higher β makes rent-seeking investments more profitable. The value of θ increase for both reasons which again reduces the growth rate further (according to (24)).

To prove that θ goes up with β we utilize that $r \equiv (1+\beta)p^s - 1$ to write the marginal return on investments as

$$(26) \quad (1 - \eta) \left[\frac{1 + \beta (1 - (1 - \theta)s(p))}{\eta s(p)} hm \right]^\eta = (1 + \beta)p - 1$$

(25) and (26) are two equations in θ and p for each value of β . By differentiation we obtain

$$\begin{aligned} -Adp + Bd\theta &= Cd\beta \\ -dp + \phi_\theta d\theta &= -\phi_\beta d\beta \end{aligned}$$

where

$$A = (1 + \beta) \left[\frac{s' [p(1 + \beta) - 1]}{s} + 1 + \beta (1 - (1 - \theta)s) \right] > 0$$

$$B = \beta \eta s [(1 + \beta)p - 1] > 0$$

$$C = p(1 - \eta) [1 + \beta (1 - (1 - \theta)s)] + \eta [(1 - (1 - \theta)s) + p(1 - \theta)s] > 0$$

Using Cramer's rule on this system we obtain

²¹ If $\phi(1, \beta) \geq (r - \beta)/(1 + \beta)$ no insiders allocate any of 'their' money to ordinary investments.

$$\frac{d\theta}{d\beta} = \frac{A\theta_{\beta} + C}{B - A\phi_{\theta}} > 0$$

If the speculations above give a relevant description, higher bribes are doubly harmful to growth. First, the wedge between money saved and capital put into productive use widens. As a consequence the next generation receives smaller technological spillovers and growth slows down. Second, higher bribes mean declining profitability on ordinary investments relative to rent-seeking investments. This implies that ordinary investments are crowded out as the proportion of these investments in total investments go down. The result is a further decline in the growth rate.

7. Concluding Remarks

Our attention has so far been focused on internal savings and investments even though Kenya has depended heavily on foreign funding. Foreign direct investments, however, only averaged 30 million US dollars per year during the 1980s. The investment code has been directed toward monetary short-term gains, while benefits in the form of technology transfer and general economic development have been less prominent among the motives. Recently Kenya has introduced some liberalization measures, but still it is difficult (or costly) for a newcomer to find his way in the system of controls. Foreign investors need basic approvals from the relevant government departments and the Central Bank, and on top of this work permits and various licences. Up till now few external investors have come in. The reason might be that the 'under the table' costs are too large. The officers issuing permits might ask for shares in the company or money, and then influential politicians might want their cut too.

This is yet another example of how the economic problems of Kenya have their roots in the political power structure of the country. We have argued that the structure emerged after independence and became distinct under Moi's presidency. Central is the issue of coalition building where both Kenyatta and Moi tried by similar means

to promote the interests of their subnationalist followers.²² The main difference between the two is that Moi in the beginning had the more acute need for a broader power base and therefore was willing to intervene more to stay in power. The patron-client relationships that were established by the coalition building efforts have been a great strain on resource allocation in Kenya. To obtain loyal followers, the public sector has become seriously overmanned and the merit principle has been neglected in hiring and promotion decisions. Moreover, honesty among politicians and civil servants have been allowed to decline. As a result the administrative culture both in private business and in governmental affairs is strongly afflicted by corruption. On top of this comes the heavy engagement of politicians and civil servants in business activities that couple politics with particularistic business interests.

As shown in the preceding sections all three features — public sector surplus labour, corruption and straddling — constitute major growth constraints. However, if these structures are so detrimental to efficiency and development, one might wonder why they have been sustained for so long. The answer may simply be that the inefficient system is maintained by the ruling elite for distributional reasons. Compared with feasible alternatives, the present system seems to provide a larger share of a smaller pie to the core insiders in Kenya. This is consistent with the view of North (1990) who argues that the state often functions as a predator. He also reminds us of the fact that historically stagnation rather than growth has been the rule. In explaining why, he focuses on transaction costs of taxation that may have some relevance for present-day Kenya as well. A state that tries to maximize its net revenue may find it easier to tax large monopolies or parastatals rather than dispersed small enterprises. An easily taxed but inefficient ownership structure may also exclude competition that would harm the private businesses of the ruling elite.

²² As stated by Throup (1988, p. 34),

Kenyatta and Moi had similar ambitions in that both attempted to promote the economic interests of their subnationalist followers and have also used similar political methods of factional manipulation to achieve these ends.

Until recently the political set-up in Kenya has made it difficult for outsiders to form a coalition sufficiently strong to bring about a change in government or in its policies. The present shift towards a multi-party system, however, may have a chance to induce some improvements. In particular the scope for rent appropriation, of the type discussed in the preceding sections, may be reduced. Yet it would be overoptimistic to believe that there will be a drastic break with the past.

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